WORKING PAPER NO.27

Economic Growth and Development in Malaysia: Policy Making and Leadership

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About the Series

The Commission on Growth and Development led by Nobel Laureate Mike Spence was established in April 2006 as a response to two insights. First, poverty cannot be reduced in isolation from economic growth—an observation that has been overlooked in the thinking and strategies of many practitioners. Second, there is growing awareness that knowledge about economic growth is much less definitive than commonly thought. Consequently, the Commission's mandate is to "take stock of the state of theoretical and empirical knowledge on economic growth with a view to drawing implications for policy for the current and next generation of policy makers."

To help explore the state of knowledge, the Commission invited leading academics and policy makers from developing and industrialized countries to explore and discuss economic issues it thought relevant for growth and development, including controversial ideas. Thematic papers assessed knowledge and highlighted ongoing debates in areas such as monetary and fiscal policies, climate change, and equity and growth. Additionally, 25 country case studies were commissioned to explore the dynamics of growth and change in the context of specific countries.

Working papers in this series were presented and reviewed at Commission workshops, which were held in 2007–08 in Washington, D.C., New York City, and New Haven, Connecticut. Each paper benefited from comments by workshop participants, including academics, policy makers, development practitioners, representatives of bilateral and multilateral institutions, and Commission members.

The working papers, and all thematic papers and case studies written as contributions to the work of the Commission, were made possible by support from the Australian Agency for International Development (AusAID), the Dutch Ministry of Foreign Affairs, the Swedish International Development Cooperation Agency (SIDA), the U.K. Department of International Development (DFID), the William and Flora Hewlett Foundation, and the World Bank Group.

The working paper series was produced under the general guidance of Mike Spence and Danny Leipziger, Chair and Vice Chair of the Commission, and the Commission's Secretariat, which is based in the Poverty Reduction and Economic Management Network of the World Bank. Papers in this series represent the independent view of the authors.

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Abstract

Malaysia is a multiethnic, upper-middle-income country that has relied heavily on income from its natural resources to engineer successful diversification into manufacturing and sharply increased incomes for all ethnic groups. This paper examines the role of the policy-making process and national leadership in effecting this structural change and growth with equity. It discusses the government's role in transforming corporate ownership patterns while nurturing industrial enterprises into niche products within complex value-added chains. At the same time, the paper underscores the difficulties and costs of attempting to move into areas where an economy has no strong advantages, in this case heavy industries. Privatization is seen to have been a powerful tool for expanding private enterprise despite limited entrepreneurial skills, but it is questionable as a sustainable strategy; the aggressive formation of new firms seems to offer better long-term prospects. An appropriate regime of policy making and implementation is required, characterized by political determination, stability, high attention to growth with equity, experimentation, and an ability to learn through implementation—both at home and from the experience of others. These are key factors accounting for the relative success of Malaysia. Nothing in the Malaysian experience suggests that it is possible or desirable to undertake reforms serially; in fact, the evidence suggests that the "reform cluster" approach to policy implementation is more effective because it addresses several coordination problems at the same time.

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1. Introduction

Just a few years after independence from the United Kingdom in 1957, had the World Bank's country-classification system been in place, Malaysia would have qualified as a middle-income country. Since then, it has continued to enjoy relative prosperity, initially as a commodity exporter (rubber, tin, then palm oil and petroleum), with total income rising at 6–7 percent each year from 1970 until 2000. As a result, the number of poor persons (that is, those consuming less than the purchasing power parity US$1 per day metric) has fallen to fewer than a million, or 3.9 percent of the population of 26.2 million people (compared to about half of the population in 1970).

With a per capita yearly income measured at about US$5,300 in 2007, Malaysia is now an upper-middle-income country. It has gone through several of the structural changes that its income comparators have experienced; nevertheless, it remains highly dependent on favorable external terms of trade to support domestic economic growth (figure 1). The share of agriculture has fallen from above 30 percent of GDP to below 10 percent, and that of industry (manufacturing) rose from 27 (12) to about 50 (31) percent. The initial growth response to the purposeful and increased industrialization of the economy from the mid-1970s was favorable, with volatility declining and the overall rate of growth rising towards 10 percent per year in the late 1980s (figure 2). FDI and manufactured exports (especially high technology products) played an important role, with the latter rising from 5 percent of total exports to above 75 percent today, even as the share of total exports rose from 40 percent (mainly commodities) to 80 percent of GDP.

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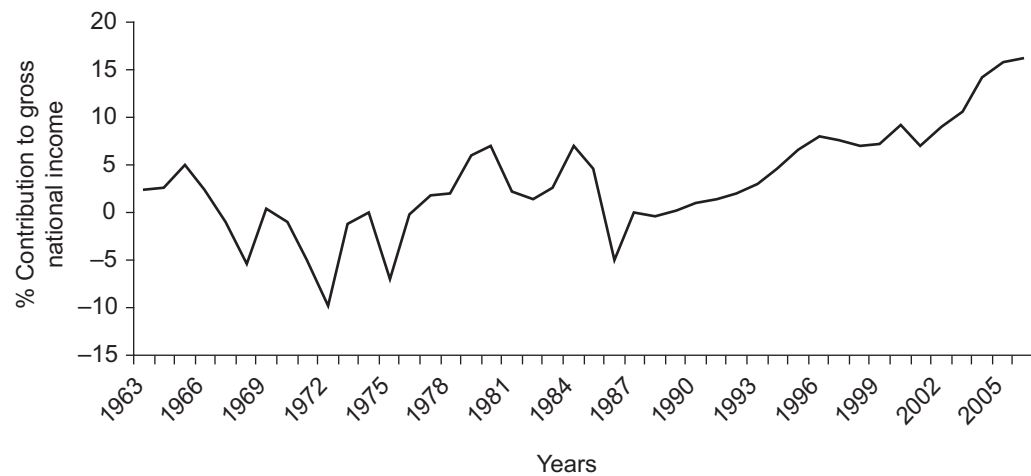
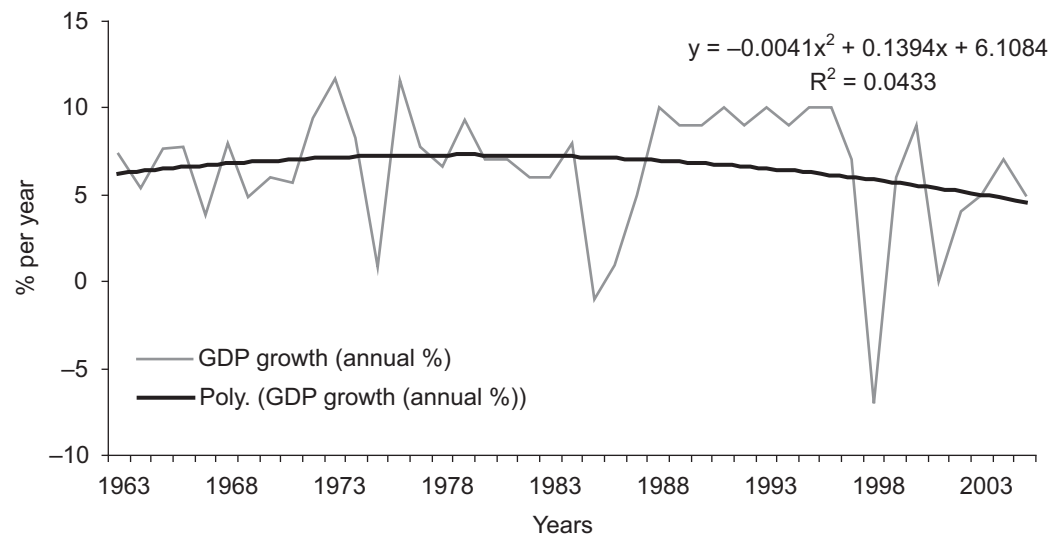
Figure 1: Terms of Trade Contribution to National Income, 1963–2006

Source: World Bank.

Figure 2: National Income Growth Trend, 1963–2007

Source: World Bank.

Capital formation in the economy stepped up sharply in the late 1980s, with a government-led heavy industry push paralleling a high rate of domestic and foreign private investment (from an average 17 percent of GDP in the 1960s to 23 percent in the 1970s and 29 percent in the 1980s). It peaked at 44 percent in 1995, but plummeted after the Asian financial crisis and has stood at an average 22 percent of GDP since 2000. A combination of domestic and external factors dampened growth over the period 2001–07 to about 4 percent per year.

Malaysia is a pluralistic society, but with sharp cleavages in economic position, religion, and language between the majority *Bumiputera* (literally, sons of the soil, which includes Malays and other indigenous groups), the Chinese

(currently 26 percent of the population), and the Indians (8 percent). However, following racial riots in 1969, the Malaysian authorities formulated economic and social policies based on affirmative action and exceptional sensitivity to income distribution. Largely, they have managed to contain the extreme tendencies and pressures on race relations that can be endemic in a multiethnic society. Growth and development in a divisive society, it appears, have been associated with improving equity and security.

The purpose of this case study on Malaysia is to reexamine the growth record of the Malaysian economy in order to consider the role of policies and leadership. The points raised by the World Bank's Commission on Growth and Development will guide this reassessment. The initial sections will highlight the key growth features of the economy, focusing on structural changes and economic transformation. Manufacturing receives special attention, with separate sections on electronics and electrical products, the automotive industry, rubber-based products, and palm oil products. The information on these industries supplies a context for the assessment of policy motivations and approaches. The discussion will also highlight the unfolding of privatization and development of the Multimedia Super Corridor (MSC) in Malaysia, both of which the authorities considered to be powerful instruments in achieving rapid industrialization. Separate sections take up the role of government and good governance in economic growth, leadership issues, policy learning processes, and implementation. Finally, some possible lessons will be summarized.

2. Overview of Economic Growth

Population and Socioeconomic Context

At independence (from the United Kingdom) in 1957, Malaysia had a population of just 7.4 million. Its population has since grown rapidly, such that by 2005 the country had some 26.8 million people and, on current estimates, will rise by 2010 to nearly 29 million. The current population shares reflect major changes over time in favor of the *Bumiputera*, largely because of their higher fertility levels. Apart from natural increase, population growth reflects a steady influx of immigrant labor, primarily from Indonesia, the Philippines, Bangladesh, and Nepal.

Before 1957, Malaysia was a low-income agrarian economy, whose mainstays were rubber and tin production and entrepôt trade centered on Penang and Malacca. Business enterprises were small-scale, largely localized, and predominantly family-based. Over time, the economy has diversified beyond agriculture and primary commodities, such that manufactured goods now account for a larger share of GDP and total exports. Urbanization has been rapid; in 2005, some 63 percent of Malaysia's population lived in urban areas, compared with just about a quarter in 1957. Although more urbanized today,

historically the *Bumiputera* were rural-based. By contrast, the Chinese have always been predominantly urban.

Since 1970, Malaysia has based its economic development strategy on three long-term policies: the New Economic Policy (NEP), 1970–90, the National Development Policy (NDP), 1990–2000, and the National Vision Policy (NVP), 2001-10. Although the emphasis in these long-term development policies has always been on economic growth, Malaysian development intends to benefit all groups or communities in society in an equitable manner. Beginning in the late 1960s, specifically following racial riots across the country, distribution issues became more important and moved to the forefront. The overriding objective of the NEP, maintained in the NDP and the NVP, was to preserve national unity by eradicating poverty irrespective of race, and by restructuring Malaysian society to reduce the identification of race with economic function and geographical location. Direct policies to assist the *Bumiputera* obtain parity with the non-*Bumiputera* in income and wealth lay at the heart of the distributive strategy. Growth with equity continues to be the guiding development strategy.

Early Diversification and Growth

The post-war growth of the Malaysian economy falls into four broad phases. The first phase (1957–70) covered the years immediately after the country gained independence from British rule. Diversifying production and incomes away from tin and rubber was the fundamental strategic policy thrust in the light of high volatility in their prices and an anticipated decline in long-term commodity prices, especially rubber. The following 20 years (1971–90) consisted of defining events and strategies that fundamentally restructured the economy, and may be called the distributional epoch in modern Malaysian economic history. The race riots of May 1969 were a turning point and led to the introduction of the New Economic Policy (NEP) in 1971, the publication of the Second Malaysia Plan (1971–75), and the Outline Perspective Plan (OPP) (1971-90). The 1991–2000 growth phase traversed the difficult years of the Asian financial crisis and the period of exchange controls. The more recent phase (2001–07) is one of slow growth following the terrorist attacks in the United States on September 11, 2001, as well as more competitive external economic conditions that have heightened some of Malaysia's vulnerabilities.

For most of the 1950s and 1960s, the main development issue was the dependence of the economy on natural rubber and on the production of tin. A central issue concerned the volatility of the price of rubber and tin, their impact on the economy, and the long-term prospects of the economy with continued dependence on natural commodities. Projections from a variety of sources showed that rubber prices were on a downslide. The competition from synthetic rubber added to the worries of development planners and policy makers.

Economic diversification has been a key theme of long-term strategy in Malaysia and is a continuing concern today. The key lessons of policy making

over the past 50 years are anchored in state-led attempts to diversify sources of income for the Malaysian economy, even as sociopolitical engineering was used to build the Malaysian nation. Another feature related to this diversification imperative was the tendency for new government programs and policies to be introduced precisely when forward projections of commodity markets of interest to Malaysia signaled impending slowdowns. Consequently, diversification had two components: *first* was the diversification of agriculture from rubber into the cultivation of palm oil (and other crops) on a large scale; and *second* was the diversification away from primary into secondary industries, especially manufacturing.[2]

Diversification was successful. Over the 1948–52 period rubber accounted for almost 70 percent of the total output value of the major agricultural commodities; in the 1963–67 period, its share declined to about 65 percent of total agricultural output (Lim, 1973). As a share of total national output, rubber fell from 38 percent to 15 percent. Although the successful diversification strategy consisted of a number of elements, the decision to increase the cultivation of oil palm in the 1960s was a very significant policy change and was a key component of agricultural diversification. Public and private investment in oil palm estates gained momentum from the 1960s. The Federal Land Development Authority (FELDA) spearheaded this effort. Over 1956–66, 80 percent of developed acreage was devoted to rubber and 20 percent to oil palm. From 1966–70, covering the First Malaysia Plan period, the acreage shares of the two crops were almost reversed; oil palm acreage increased from about 99,000 acres in 1960 to 335,000 acres in 1970, a more than three-fold increase. Palm oil production increased from about 90,000 tons in 1960 to 396,000 tons in 1970.

Malaysian economic policy making in this early period expressed the boldness and vision of government planners and their ability to mobilize support for "experiments" in both the government budget as well as from private investors. Betting on oil palm in 1960 was a risky proposition. One sign of this was the insignificant levels of European and Chinese investment since the 1920s in the crop, despite relatively favorable returns to both labor and land. Such leapfrogging over private market perceptions remained a characteristic of the leadership and bureaucracy well into the 1990s, accounting for many bold

[2] While diversification was the driving force in much of the economic strategy of that time, state-supported modernization of existing production was not neglected. For example, the government channeled resources into R&D in rubber production, and over the 1960s several advances were made in raising the productivity of rubber estates and smallholders. New high-yielding rubber clones increased the productivity of the estates and smallholders in the 1960s and 1970s. Modern agronomic techniques also contributed to raising the productivity of rubber production. Productivity gaps between the large estates and rubber smallholders, despite the utilization of the high-yielding clones, remained sizable but the incomes of rubber smallholders recorded increases and helped to alleviate poverty in the rural areas. Similarly, infrastructure and extension schemes supported smallholder rice production, later crop subsidies, price supports, and government procurement and marketing.

experiments in economic policy reform and industrial promotion.[3] In most cases, policy makers applied some of the basic precepts of investment planning under conditions of high uncertainty, including starting with pilots, devising exit strategies, and offloading much of the risk on parties outside the public sector. Arguably, risk-taking became increasingly constrained by the NEP and the distributional epoch of Malaysian policy making, as the front-loading of economic benefits to disadvantaged groups, primarily *Bumiputera*, took precedence; burden sharing diminished rapidly; and there was a gradual, but visible, concentration of risks and costs that fell on the public sector (both on- and off-budget). Another consequence of this in subsequent periods was the increasingly higher protection given to uneconomic activities to achieve short-term distributional objectives. For example, nearly a third of rice production judged to be inefficient was subsidized heavily through the government budget well into the 1980s (World Bank, 1984).

What happened to diversification away from primary industry? Structural change in the Peninsular Malaysia economy was relatively rapid over the 1955–70 period (Lim, 1973). The primary sector's share of GDP (in constant 1960 prices) declined from about 46.5 percent in 1955 to 36.1 percent in 1966. Agriculture's share recorded rapid declines, from 40.2 percent in 1955 to 28.4 percent of GDP in 1966. The share of secondary industries rose from 11.2 percent to 15.4 percent, and the tertiary sector share increased from 42.3 to 48.6 percent of GDP over the same period. While no data are available for the 1950s, the manufacturing share of GDP reached slightly more than a tenth (10.9 percent in 1966), compared to about 8.8 percent in 1961. However, there were no breakthroughs during this earlier period, which saw some diversification in agriculture and public investment to physically integrate the domestic economy and improve the livability of cities.

The Rise of Manufacturing

The 1970s ushered in a new phase of economic growth, marked by the rapid rise of construction and manufacturing and a strong strategic emphasis on equitable or fair distribution, specifically through affirmative action policies. By 1990, the economy was more industrialized, despite being buffeted by massive shocks—for example, the oil crises of 1973–74 and 1978–79 and the global slowdown in demand for electronics and primary commodities in 1985–86.

Export-oriented manufacturing industries gained momentum in the early 1970s. Foreign direct investment (FDI) in export-oriented firms was promoted actively with the introduction of the Investment Incentives Act of 1968, Free Trade Zone Act of 1971, and the Promotion of Incentives Act of 1986. Prior to

[3] For example, faced with pressures from the development of synthetic rubber on the market for natural rubber, in addition to the modernization strategies mentioned in the previous footnote, the Malaysian authorities decided early on to enter into an aggressive buildup of a petrochemical industry in order to insert itself into the value chain of the downstream rubber product industry.

these investment promotion instruments, industrial growth was driven by an import substitution strategy (IS) with the introduction of the Pioneer Industry Ordinance, 1958. The establishment of the Malaysian Industrial Development Authority (MIDA) in the mid-1960s was a landmark in the drive towards industrialization.

As a dependent colonial economy, Malaysia concentrated on the exports of primary raw materials and imported manufactured products. In 1947, agriculture employed more than two thirds of the labor force, 22.5 percent were in the tertiary sector, 2.5 percent in mining, and 6.7 percent in manufacturing (Hoffmann and Tan, 1980). The proportions remained largely unchanged until independence. During the colonial period, agricultural processing was the main manufacturing activity, but in the 1960s and 1970s newer industries such as beverages, textiles, chemicals and chemical products, and transport equipment began to emerge, almost entirely in the private sector. Unlike other countries that were industrializing during that period, however, external tariff rates were modest and intended mainly for revenue raising purposes. Overall, the mean ad valorem rate was 25 percent with narrow dispersion, and the main instrument for industrial development was the tax concession mechanism operated under the Pioneer Industries Ordinance.

Under such conditions, the industries that grew were those that had some "natural protection" due to high transportation costs and location advantages. The manufacturing industries that enjoyed such advantages were the primary processing industries, including the processing of agricultural, mining, and forestry products, and domestic market-oriented industries such as food products, printed materials, furniture, rubber products, and building supplies (for example, cement, bricks, and light engineering goods). Estimates of direct and indirect factor intensities (Leontieff tests) showed that Peninsular Malaysia's trade in manufactured goods was consistent with the factor proportions theory, that the country had developed comparative advantage in resource-based manufacturing industries, and that its imports were more capital intensive and exports more labor intensive in the latter period (Hoffman and Tan, 1980).[4] The estimates indicate that growth, led by Malaysia's labor-intensive manufactured exports, was underway by the early 1970s.

3. The Push for Industrialization

At the broadest level, discussion of Malaysia's push for industrialization is motivated by three observations. *First*, although there was rapid diversification away from resource-based industrial exports towards non-resource-based

[4] The calculations were for the years 1963, 1968, and 1971 and excluded nascent resource-based industries such as palm oil, wood milling, rubber processing, petroleum and coal, and tin smelting. Different assumptions on capital were used to test the sensitivity of the estimates.

industries, recent years have witnessed slightly faster growth in the latter (table 1). Although agriculture's share of total output has declined sharply—structural changes that could be anticipated given that agriculture's share of GDP was, for Malaysia's level of income, somewhat higher than normal—the recent weaker performance of non-resource-based industries has kindled a debate about future government strategy. *Second*, the future of labor-intensive industries is a source of concern, not just because of the high dependence on electronics/electrical products and textiles but also because of rapidly increasing labor costs in Malaysia. *Third*, and related to this, there has been a strategic push in recent years to seek out new growth areas and push towards higher value–added and knowledge-based industries with the erosion in Malaysia's comparative advantage in labor costs and labor-intensive manufacturing industries. In this respect, Malaysia finds itself in a similar situation as its East and South Asian neighbors, and may need to take calculated risks as it did during the first phase of its industrialization, but within an entirely different socioeconomic context.

One of the exceptional features of Malaysian policy making is the very detailed consideration of options that preceded implementation, the involvement of large segments of the public and business sectors in the specific design of policies, and the bundling of related policy measures into packages that overcame legislative and coordination problems. Analytically, the last of these is an important concept, quite different from some of the evolving development approaches in academic and international institutions. Little in the "reform cluster" approach adopted by the Malaysians would support the stylized (and often purely understood) Chinese "crossing the river by feeling the stones" methods, formalized in the "binding constraints" or "growth diagnostic literature" promoted in some circles.[5]

For the purposes of this case study, and to better illustrate the reform clusters approach, it is useful to illustrate policy making, leadership, and learning within the specific industrial contexts in which they occurred, rather than to remain at the level of broad concepts. The focus here is on four manufacturing industries: (i) rubber and (ii) palm oil products (both resource based); and (iii) electronics/electrical products and (iv) the transport/automobile industries (both of which are not resource based).

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[5] See Hausman, et al. (2005). In practice, the "binding constraint" approach tends to stretch the credulity of development practitioners, but academics usually attribute this to the formers' lack of competence in implementing, all else being equal. Among academics, the inability to define the boundaries of constraints presents problems for rigorous empirical testing.

Table 1: Exports of Manufactured Products

	1996		2000		2005		1996–2005
Industry	**(RM million)**	**Share (%)**	**(RM million)**	**Share (%)**	**(RM million)**	**Share (%)**	**Average annual growth (%)**
Total manufactured exports [a]	**154,664.7**	**100.0**	**309,427.4**	**100.0**	**413,132.7**	**100.0**	**11.2**
Non-resource based	**126,703.8**	**81.9**	**265,828.7**	**85.9**	**340,584.8**	**82.4**	**11.1**
Electrical & electronics products	96,800.6	62.6	219,583.0	71.0	264,698.9	64.1	11.4
Machinery, appliances & parts	7,471.4	4.8	10,825.9	3.5	18,120.6	4.4	9.9
Optical & scientific equipment	3,119.1	2.0	6,811.3	2.2	12,317.7	3.0	15.6
Manufactures of metals	3,738.9	2.4	6,870.5	2.2	10,847.9	2.6	11.7
Textiles & clothing	6,816.0	4.4	10,265.3	3.3	10,289.1	2.5	4.9
Transport equipment	4,658.0	3.0	2,975.2	1.0	6,997.9	1.7	2.9
Manufactures of plastics	1,531.3	1.0	3,829.8	1.2	6,696.3	1.6	16.8
Iron & steel products	1,474.3	1.0	2,346.4	0.8	7,002.8	1.7	19.1
Jewelry	1,094.2	0.7	2,321.3	0.8	3,613.6	0.9	11.8
Resource based	**23,246.0**	**15.0**	**38,505.3**	**12.4**	**63,378.8**	**15.3**	**11.8**
Chemicals & chemicals products	5,829.1	3.8	12,918.6	4.2	26,301.3	6.4	17.4
Wood products	8,146.8	5.3	11,157.6	3.6	14,638.9	3.5	8.3
Rubber products	3,607.7	2.3	4,720.8	1.5	6,985.5	1.7	7.8
Processed food	2,333.4	1.5	3,408.4	1.1	6,529.9	1.6	10.8
Non-metallic mineral products	1,641.1	1.1	2,567.7	0.8	2,934.3	0.7	5.8
Petroleum products	413.4	0.3	1,128.9	0.4	2,214.4	0.5	21.2
Paper & pulp products	698.4	0.5	1,396.3	0.5	2,073.4	0.5	10.3
Beverages & tobacco	576.1	0.4	1,207.0	0.4	1,701.1	0.4	15.7
Other manufactures	**4,714.9**	**3.0**	**5,093.4**	**1.6**	**9,169.1**	**2.2**	**9.0**

Source: Third Industrial Master Plan, Government of Malaysia.

a. The value of the total export of manufactured products, compiled by Ministry of International Trade and Industry (MITI), differs from the value of the total export of manufactured products contained in the Ninth Malaysia Plan, due to the difference in product groupings adopted by MITI and Economic Planning Unit (EPU). For example, in 2005, the figure by MITI is RM 413.1 billion, while the figure by EPU is RM 429.9 billion.

Further, in selecting these industries for specific attention, the case study is able to reexamine through the leadership prism not just the past, but also challenges and opportunities that confront policy makers in Malaysia today. The two resource-based industries are important because they raise questions about the potential for further developing resource-based manufacturing industries based upon Malaysia's comparative advantage as a leading producer of oil palm and natural rubber. The electronics/electrical products industry is the single most important manufacturing sector, making a considerable contribution to the industrialization of the economy. It continues to maintain a preeminent position despite being pressured by recent events—for example, the semiconductor recession in 2001 and the emergence of China as a destination for electronics-related FDI. The automobile industry, an example of a heavy industry, is included because important policy changes have recently resulted from a fundamental reevaluation of the big push strategy introduced in the late 1980s.

In addition to the focus on four industries, it is useful to illustrate two other contexts in which economic policy making and leadership played out during Malaysia's economic development. The first is the early embrace (1983) of a "privatization" policy in Malaysia. This policy initiative stemmed, first, from concern about the rapid growth of Malaysia's public sector during the early stages of the NEP, and its relatively weak industrial performance. In addition, Malaysia's privatization initiative was also based on the "Japan Inc." model that viewed the country as a single corporation, with the government providing and helping maintain an enabling environment for business and the private sector operating as the engine of growth. This anticipated, by several years, the formalization of such an approach by the broader development community.

A second set of strategies is equally important, because it illustrates the policy makers' return to some of the calculated risk-taking behaviors seen prior to the promotion of industrialization in the 1970s, and referred to earlier. These strategies were the first concerted attempt at the national policy level to initiate a transition from development based on resources and traditional technology toward a knowledge-based economy, and thereby ride the wave of industrial change and globalization that was sweeping the world. The launch of the Multimedia Super Corridor (MSC) in 1996, although affected strongly by fallout from the Asian financial crisis of 1996–98, is intended to build on Malaysia's current strengths in electronics, skilled labor, and high-quality infrastructure to become a more visible regional and global player in the development and application of information and communications technology (ICT).

Electrical and Electronics Products

Electrical and electronics products, which together account for about 30 percent of value added, form the largest subsector of manufacturing (also in terms of export earnings, investments, output, and employment), and have long been considered to be the spearhead of Malaysia's industrialization drive. As shown

in tables 2 and 3, electronic components (for example, semiconductors and printed circuit boards) and industrial products (for example, telecoms equipment, office equipment, and multimedia products) have a much larger share of investment and gross exports than consumer electronics (for example, audio and video products). However, electrical products, although a smaller share of the investment and trade picture, have recorded the fastest growth in gross exports.

The promotion of the electronics industry began in 1970, with the initial companies employing less than 600 workers. By 2004 total employment had increased to about 369,000, or about 36 percent of total employment in manufacturing. The Malaysian leadership courted foreign investors, and the latter were responsible for the initial growth of the electronics industry (dominated by American and Japanese multinational corporations [MNCs]). Ample labor, a market-oriented economy, a young, educated labor force, and good infrastructure provided strong attractions. Over the 1990s, the outsourcing of manufacturing activities and the development of Malaysia as a regional products and distribution center for high-end electronics products has contributed to the structural transformation of the electronics industry. Structural change in the electronics industry has, since 1999, led to industrial electronics overtaking electronics components. Some 901 new companies entered the industry over 1996–2005. The increasing importance of industrial electronics has been due to the expanding manufacture of high value–added products such as computers, computer peripherals, and telecommunications equipment (Ministry of Trade and Industry, 2006). New high-end products include fabricated wafers, mobile phones, telecommunications equipment, computer notebooks, and servers. New services, including the design of integrated circuits, prototyping, testing, and failure analysis have also grown and expanded.

Table 2: Investments in Electrical and Electronics Industry

	1996–2000		2001–2005		1996–2005	
Product category	**Value (RM bln)**	**Share (%)**	**Value (RM bln)**	**Share (%)**	**Value (RM bln)**	**Share (%)**
Total	**41.0**	**100.0**	**43.3**	**100.0**	**84.3**	**100.0**
Electronics products	*36.5*	*89.0*	*40.7*	*93.9*	*77.2*	*91.6*
Components	30.5	74.4	24.0	55.3	54.5	64.7
Industrial	4.6	11.2	14.0	32.3	18.6	22.0
Consumer	1.4	3.4	2.7	6.3	4.1	4.9
Electrical products	*4.5*	*11.0*	*2.6*	*6.1*	*7.1*	*8.4*

Source: MITI (2006).

Table 3: Exports and Imports of Electrical and Electronics Products

Product category	1996		2000		2005	
	Exports	Imports	Exports	Imports	Exports	Imports
	(RM billion)					
Total	**99.3**	**76.6**	**221.9**	**156.4**	**265.1**	**194.1**
Electronics products	*92.3*	*68.1*	*221.9*	*142.5*	*238.5*	*177.2*
Components	39.7	49.7	84.0	111.8	100.4	120.7
Industrial	32.7	17.9	101.4	30.0	115.4	54.5
Consumer	19.9	0.5	26.5	0.7	22.7	2.0
Electrical products	*7.0*	*8.5*	*10.0*	*13.9*	*26.6*	*16.8*

Product category	1996–2005		1996–2005	
	Exports	Imports	Exports	Imports
	(RM billion)		Average annual growth (%)	
Total	**1,890.3**	**1,366.3**	**11.1**	**10.4**
Electronics products	*1,772.3*	*1,245.5*	*10.8*	*10.8*
Components	760.7	913.4	10.7	9.9
Industrial	795.6	332.7	15.4	12.9
Consumer	215.9	9.4	0.6	10.5
Electrical products	*118.1*	*120.8*	*120.8*	*7.1*

Source: MITI (2006).

There are three electronics clusters, with Penang in the north occupying a preeminent position. The government established export processing zones (EPZs) in all three clusters to attract FDI. Incentives were granted to the foreign-owned companies that were operating in the EPZs, such as pioneer status, labor utilization relief, investment tax credits, accelerated depreciation allowances, and export refinancing facilities. The semiconductor cluster around Penang and adjacent areas, especially the Kulim High Technology Park, has been hosting major companies and manufacturers of components and parts, engineering support industries, and dedicated services, including logistics. Training centers and higher learning institutions supporting R&D activities have also grown around the electronics cluster in the north. The Klang Valley and Johore, in the south, are the other two important clusters. To some extent, the MNCs located in the EPZs transfer technology to the host economy. They helped enhance skills and employees of MNCs, which have been able to set up new firms that are linked to the electronics industry. In Penang, technology transfers increased specialization and helped to create a network of second- and third-tier components suppliers. Some of the supplier firms have developed their own process engineering and original equipment manufacturing capabilities by supplying the MNCs.

Rubber Products

Advances in technical knowledge in rubber tapping, use of vulcanization, and increasing demand for rubber from the industrialized countries led to high investment in by Europeans and Chinese in rubber plantations and, later, by indigenous smallholders. At independence, given the strong foundation in rubber cultivation and exports, there were high expectations that rubber products could make a significant contribution to manufacturing output. Now, after more than 120 years, the rubber industry is moving into a new growth phase with efforts to develop new rubber products, and is providing another example of diversification and moving up the value-added chain.

Within the industry, tires and tire-related products have shown the strongest export growth in recent years, followed by latex products (for example, medical devices, gloves) and industrial and general rubber products (for example, conveyer belts, floor coverings), although rubber footwear has also shown strong performance (table 4). The United States is the single largest export market for Malaysia's rubber products. Malaysia now accounts for 80 percent of the world's exports of catheters, 70 percent of latex thread, and 60 percent of natural rubber gloves. A number of Malaysian companies have become major global producers of latex rubber, with their own brands and marketing channels and with overseas operations. Latex products have moved higher up the value-added chain through the introduction of the Standard Malaysian Glove (SMG) scheme, technological developments such as polymer-coated and powder-face gloves, and specialty gloves. However, cheaper products from abroad, especially from within ASEAN and particularly of industrial and general rubber products, tires, and tire-related products, have resulted in rising imports.

Table 4: Trade Performance of Rubber Products

	1996	2000	2005	1996–2005
		(RM million)		Average annual growth (%)
Exports				
Total	**4,219.0**	**5,581.7**	**7,901.7**	**7.4**
Latex products	3,381.8	4,455.7	6,215.3	7.2
Industrial & general rubber products	389.4	555.3	738.9	7.0
Tires and tire-related products	207.4	257.2	484.2	10.8
Footwear	240.4	313.5	463.3	6.9
Imports				
Total	**632.1**	**1,027.1**	**1,750.3**	**11.3**
Industrial & general rubber products	350.9	537.4	680.8	8.4
Tires and tire-related products	100.0	199.0	516.0	15.6
Latex products	68.3	128.1	323.3	15.0
Footwear	112.9	162.6	230.2	9.4

Source: MITI (2006).

Supply shortages in latex have also led to increases in imports. Imports of gloves and condoms by Malaysian-owned companies from their overseas operations, for repackaging and other value-added activities for re-export, are one illustration of the kinds of adjustments required in the face of international competition. Exploiting growth opportunities in higher value-added latex products was the route taken to meet competition, and is likely to be the future growth path. The Malaysian rubber industry is also pursuing automation technologies and branding strategies. High-end pharmaceutical or medical products, such as coronary catheters used in surgeries, specialty gloves used in clean rooms, and other medical devices, will expand the product range (MITI, 2006).

Oil Palm Products

Palm oil, rubber, and wood-based products are the three leading resource-based manufacturing industries. With the diversification of the agricultural sector away from rubber, oil palm cultivation became a major contributor to export earnings. Palm oil is a key commodity export for Malaysia, and the processing of palm oil for export products has been part of the overall industrialization strategy. A natural-resource-based industrialization strategy, it has been argued, can bring benefits to economies that produce primary commodities, and several developing countries have tried to go down this route (Yeats, 1991). Markets for processed commodities may be more stable than those for raw commodities, and could in the long run yield more stable and larger secular price increases.

Primary processing industries (palm oil processing, wood mills, petroleum products, rubber processing, and nonferrous materials) dominated the manufacturing sector by the early 1960s. In 1963 rubber processing and nonferrous metals (mainly tin) accounted for more than half of manufacturing output, and if palm oil processing (3.7 percent) and wood mills are added, primary processing accounted for about 64 percent of manufacturing output (Hoffman and Tan, 1980). Palm oil processing increased its share of manufacturing output from 3.7 percent in 1963 to 16.2 percent in 1974. Acreage under oil palm increased while that under rubber declined over the period, especially with new plantings under the Federal Land Development Authority (FELDA). Palm oil, compared to rubber, is a more capital-intensive crop and smallholdings utilize more labor than estates (Thoburn, 1977). Until the development of FELDA in the 1960s, oil palm was an estate crop. The technological needs of processing oil palm had constrained smallholders from venturing into the industry. Oil palm also requires greater harvesting expertise and utilizes more inputs than rubber.

Table 5: Exports of Oil Palm Products

Products	1996 Value (RM mln)	1996 Share (%)	2000 Value (RM mln)	2000 Share (%)	2005 Value (RM mln)	2005 Share (%)	1996–2005 Average annual growth (%)
Total	**11,569.4**	**100.0**	**14,587.5**	**100.0**	**26,311.0**	**100.0**	**7.9**
Processed palm oil	9,222.9	79.7	9,885.9	67.8	17,808.3	67.7	5.8
Oleochemicals	1,166.6	10.1	3,036.8	20.8	5,137.8	19.5	15.4
Processed palm kernel oil	744.8	6.4	1,034.0	7.1	1,916.3	7.3	11.3
Palm oil-based finished products	62.3	0.5	402.1	2.8	829.1	3.2	28.0
Palm kernel cake	255.1	2.2	196.4	1.3	353.6	1.3	6.4
Crude palm kernel oil	117.7	1.0	32.3	0.2	265.9	1.0	16.9

Source: MITI (2006).

Technological developments in the palm oil industry increased production and the range of palm oil products. Improved breeding through better planting materials have raised productivity substantially. The use of modern processing machines increased the rate of extraction and reduced the proportion of fatty acids. The range of uses of oil palm increased with this lowering of the acid content. Hydrogenation and other improved processing methods also expanded the uses of palm oil and palm kernel oil. The range of palm oil products increased from the manufacture of soap to margarine and cooking fats, and the trend towards the utilization of palm oil for edible purposes has been increasing.

Currently, Malaysia is the world's largest producer and exporter of palm oil, with 45 percent of production and 51 percent of world exports. Processed palm oil contributes the most to oil palm industry exports, with oleochemicals (for example, fatty alcohols, soaps, printing ink) and other products (for example, biodiesel, particleboard) much smaller but growing rapidly (table 5).

Automotive Industry

In the early 1980s, the government began to make explicit its intention to devote more resources to the development of heavy industries. This was in response to an economic slowdown. Yearly economic growth of 4.9 percent for the 1981–83 period was below the growth target of 7.6 percent per year that had been set for the Fourth Malaysia Plan, 1981–85 period. Manufacturing growth (4.9 percent per year) was below half the target set for 1981–85. The plan had emphasized that heavy industries would create new engines of growth and provide strong forward and backward linkages for the development of industries. Cement, sponge iron, cold rolling mill, methanol pulp and paper, petrochemical, and automobile industries received special attention. Promotion of the automotive industry, and in particular the national car project, attracted the most controversy.

In the 1960s, the sale of completely-built-up (CBU) units imported from Europe constituted the core of the industry. After 1967, completely-knocked-down (CKD) assembly from imported kits expanded, but with some domestically

produced components, which included batteries and tires. In 1983, the government established Perusahaan Otomobil Nasional Berhad (Proton) as an automobile company and commenced operations in 1985. By 1994, Proton's annual production had increased from 8,670 units to 134,000 units and its share of the domestic car market had increased to 70 percent. Component costs accounted for 80 percent of the total costs, and imports were sourced from Japan; the strengthening of the yen in 1994 raised the production costs of Proton's cars. Proton developed a network of component manufacturers (some in-house manufacturing, some 138 domestic suppliers, and others from within ASEAN) and Proton exported cars to 30 countries (table 6). More than 70 percent of the domestic vendors were linked to technical partners from Japan. For its medium-term plan, Proton had targeted the production of 300,000–500,000 cars per year. After 10 years of commercial production Proton was producing 165,000 cars per year (1995) compared to 35,000 cars in 1985 (table 7).[6]

Table 6: Exports of Automotive Products

	1996		2000		2005		1996–2005
Segment	**Value (RM mln)**	**Share (%)**	**Value (RM mln)**	**Share (%)**	**Value (RM mln)**	**Share (%)**	**Average annual growth (%)**
Total	**1,013.1**	**100.0**	**1,516.4**	**100.0**	**2,726.9**	**100.0**	**12.0**
Passenger vehicles	477.9	47.2	344.7	22.7	411.1	15.1	−0.3
CBUs	475.5	46.9	336.8	22.2	396.3	14.5	−0.6
CKDs	2.4	0.2	7.9	0.5	14.9	0.5	28.6
Commercial vehicles	13.8	1.4	21.8	1.4	56.9	2.1	20.4
CBUs	12.3	1.2	50.6	1.4	56.2	2.1	20.6
CKDs	1.5	0.1	0.7	neg.	0.7	0.0	11.1
Motorcycles	9.7	1.0	131.3	8.7	117.7	4.3	36.8
CBUs	9.7	1.0	129.4	8.6	27.5	1.0	18.4
CKDs	nil	nil	1.9	0.1	90.2	3.3	n.a.
Parts and components	511.7	50.5	1,018.5	67.2	2,140.3	78.5	16.3

Source: MITI (2006).

Note: CBUs = completely built-up units; CKDs = completely knocked-down units; neg. = negligible; n.a. = not applicable.

Table 7: Production of Motor Vehicles

Segment	1996	2000	2005
Total (units)	**291,520**	**359,196**	**563,408**
Passenger vehicles [a]	258,474	340,518	521,384
Manufacturers	177,368	290,222	334,763
Assemblers	81,106	50,296	186,621
Commercial vehicles	33,046	18,678	42,024
Manufacturers	nil	3,994	7,231
Assemblers	33,046	14,684	34,793

Source: MITI (2006).

a. Includes vans, multipurpose vehicles, sport utility vehicles and four-wheel drive vehicles.

[6] For the views of Proton on its plans, see Salleh (1995).

Privatization Policy

The privatization initiatives illustrate several of the points made earlier about Malaysia's economic policy making, especially adoption of a reform cluster approach to address coordination issues as well as facilitate legislative passage and social acceptance of related, but distinct, policy measures. Prime Minister Mahathir Mohamad first enunciated Malaysia's privatization policy in 1983, together with the "Malaysia Incorporated" approach to development. In essence, Malaysia Inc., inspired by Japan Inc., viewed the country as a single corporation, with the government providing and maintaining an enabling environment for business and private enterprise and the private sector as an engine of growth. With growing private enterprise, government tax revenues would grow, enabling further financing of development projects. In 1985, the Economic Planning Unit (EPU) in the Prime Minister's office issued the *Guidelines on Privatization,* outlining the rationale and approach to privatization and, in 1991, the government published the *Privatization Master Plan*.

A number of factors influenced the privatization policy. The change in leadership from the administration of Tun Hussein Onn to that of Mahathir marked an important political and economic milestone. Mahathir's 22-year rule witnessed the introduction of several new policies, and privatization was a primary example. With the NEP, the public sector became more active and interventionist and public investment reached nearly half of total investment by the early 1980s. During the mid-1980s, the economy weathered a recession brought about by deterioration in the terms of trade in 1981 and 1982. The public sector deficit, which had averaged 10 percent of GDP over the 1971–80 decade, increased to 21 percent of GDP in 1982, and real growth during 1984–85 fell from 8 percent to –1 percent, before picking up again.[7] Economically, however, even by the early 1980s the performance of the expanded public sector was disappointing. In general, public enterprises suffered from unclear and conflicting objectives and performance criteria, faced massive problems of coordination, and the monitoring and evaluation of public enterprises was weak.

The *Guidelines* detailed the five objectives of privatization. *First*, reduce the financial and administrative burden of the government. *Second*, promote competition, improve efficiency, and increase productivity in the delivery of services. *Third*, stimulate private entrepreneurship and investment. *Fourth*, reduce the presence and size of the public sector with its monopolistic tendencies and bureaucratic support. *Fifth*, assist in achieving the NEP objectives, especially *Bumiputera* entrepreneurship.

The next landmark in the development of the policy on privatization was the publication of the *Privatization Master Plan* in February 1991, with the aim of expanding and accelerating the pace of privatization (EPU, 1991a). Development

[7] For an assessment of the size and growth of public enterprises see Adam and Cavendish (1995) and Mohamed (1995).

planning and the preparation of sectoral master plans have always formed an integral part of the Malaysian approach to development. The master plan, incorporating a Privatization Action Plan, was prepared around 1987 by a team of consultants. In the Foreword to the *Privatization Master Plan*, Prime Minister Mahathir noted that much experience had been gained and that it had been *"augmented by studying the methods of privatization in other countries which have adopted this approach."* An important point made in the Foreword was the change in the approach to privatization and that:

> Where, before, it was up to the interested parties to propose the privatization of Government services and corporations, now the Master Plan has identified the services and the bodies that are open to privatization proposals by the private sector. This will enable interested parties to study and make offers that will be considered on comparative merit. Only in certain cases will exclusivity be granted. Even then conditions will be attached which will prevent such exclusivity from being misused. (EPU, 1991)

The *Master Plan* also reported that the necessary actions had been taken to remove bottlenecks. Laws had been amended to allow the passage of privatization and measures had been taken to prevent abuses by privatized monopolies. Apart from expanding on the policy of privatization, the master plan focused on specific issues related to methods, valuation, personnel, legislation changes, regulatory framework, capital markets, *Bumiputera,* foreign participation, and a privatization fund. It also reported on the progress made in the privatized projects up to 1990. A key part of the *Master Plan* was the listing of privatizable government-owned enterprises (GOEs) and the Action Plan for 1991–1992.

According to the Action Plan, 424 GOEs under federal, state and local government were assessed, and 246 were considered to be privatizable. Out of the 246 GOEs, it was determined that 69 could be privatized within two years, 107 within two to five years, and the remaining beyond five years. The 246 identified projects were classified as "government-initiated privatization projects" and were to be subjected to competitive bidding. The private sector was allowed to submit privatization proposals, and on occasion a "first-come-first-served" basis and exclusivity could be entertained.

During this early phase, privatization progressed fairly well in terms of numbers. By 1990, according to the *Master Plan* some 37 projects were privatized (table 8). The list excludes the 30 government companies that were divested to Permodalan Nasional Berhad and 120 companies that were sold to the private sector before 1983. The sale of government interests in companies generated revenues of RM 100 million.

Table 8: List of Privatized Projects at end-1990

	GOE	Method	Year
	New projects		
1.	Sistem Televisyen Malaysia Berhad	BO	1983
2.	North Klang Straits Bypass	BOT	1983
3.	Jalan Kuching/Kepong Interchange	BOT	1985
4.	Labuan Water Supply	BOT	1987
5.	K.L. Interchanges	BOT	1987
6.	North-South Highway	BOT	1988
7.	Labuan-Beaufort Interconnection	BOT	1988
8.	Ipoh Water Supply	BOT	1989
9.	Larut Matang Water Supply	BOT	1989
10.	Desaru International Resort	BO	1990
	Existing projects		
11.	Sports Toto Malaysia Berhad	Sale of equity	1985
12.	Malaysia Airline System (MAS)	Sale of equity	1985
13.	RM AF Aircraft Maintenance Depot	Lease	1985
14.	Tourist Facilities at National Park	Management contract	1986
15.	Malaysian International Shipping Corporation Berhad (MISC)	Sale of equity	1986
16.	Klang Container Terminal	Lease + sale of assets	1986
17.	Semenyih Dam	Management contract	1987
18.	Marketing of Airtime, Radio Malaysia	Management contract	1987
19.	RISDA Marketing Activities	Management contract	1987
20.	Tradewinds Berhad	Sale of equity	1988
21.	Maintenance of Tube Wells, Labuan	Management contract	1988
22.	Syarikat Gula Padang Terap Sdn. Bhd.	Sale of equity	1989
23.	Cement Manufacturers Sarawak Berhad	Sale of equity	1989
24.	Government Security Printing	Lease + sale of assets	1990
25.	Shah Alam Abattoir (Swine Section)	Lease	1990
26.	Lori Malaysia Berhad	Sale of equity	1990
27.	Edaran Otomobil Nasional Berhad (EON)	Sale of equity	1990
28.	Holiday Villages Sdn. Bhd.	Sale of equity	1990
29.	Cement Industries of Malaysia Berhad (CIMA)	Sale of equity	1990
30.	Pernas International Hotels and Properties Berhad	Sale of equity	1990
31.	Paremba Berhad	MBO	1990
32.	Kumpulan FIMA Berhad	MBO	1990
33.	Sungai Long Quarry, Selangor	Sale of assets	1990
34.	Kuala Dipang Quarry, Perak	Sale of assets	1990
35.	Penanti Quarry, Pulau Pinang	Sale of assets	1990
36.	Syarikat Telekom Malaysia Berhad	Sale of equity	1990
	Corporatization		
37.	Tenaga Nasional Berhad	—	—

Source: EPU (1991).

Notes: The above list does not include privatization projects that involve divestment of government companies under the scheme of transferring GOEs to *Bumiputera*.

BO = build-operate; BOT = build-operate-transfer; MBO = management buyout.; — not available.

Revenue was also earned from lease payments (for example, Klang Container Terminal). For projects privatized through the BOT and BO methods, the financial savings amounted to RM 8.2 billion.[8] Over the period 1996-2000, 98 projects were privatized, with slightly more than half of them (51) being new projects, most of which were in construction, transportation, electricity and the gas sectors (EPU, 2001). *Bumiputera* entities controlled 67 of the 98 entities that were privatized and owned 15.6 percent of the total assets that were privatized.

Between 1983 and 2000, as a result of 203 companies being privatized, *Bumiputera* increased their share capital holdings from 21.7 percent to 25.6 percent. *Bumiputera* interests also expanded forms of control and entry into business through management-buy-outs, contracting work, and vendor development programs. Awards of contracts to *Bumiputera* were increased from 30 percent to 60 percent, and over the 2001-2005 period, 27 *Bumiputera* contractors were awarded about two thirds of the total contract value. Of the 35 companies that were approved for privatization, *Bumiputera* had a controlling stake in 24 companies, representing 17.2 percent of the total share capital. Overall, *Bumiputera* had increased their ownership of share capital in privatized enterprises to slightly more than half (51.7 percent) by 2005.

Some 35 projects were approved for privatization during the 2001-2005 period with 15 in the construction sector and eight in the electricity, gas and water sector (EPU, 2006). The BOT method was used widely for the privatized road projects with the private sector responsible for construction, operation, maintenance and financing the projects while collecting toll from the road during the concession period and returning the facilities to the government at the end of the concession period. Certain privatized projects that were strategic in nature and affected by the economic slowdown were taken over by the government. Government guarantees to the privatized projects were discontinued. However, Malaysian entities acquired a vast amount of expertise in the management of mega-projects through this interaction with foreign contractors, and are now in a position to export this expertise overseas (for example, management of infrastructure in India).

Multimedia Super Corridor (MSC)

As in earlier periods, concern about the narrow industrial base of the country combined with concerns about a possible economic slowdown to encourage policy makers to consider new sources of growth. A policy shift in growth became apparent in the early 1990s with emphasis given to ICT. The clearest manifestation of this policy shift was the launching of the MSC in 1996, promoting pictorial, moving images, sound, and text technology development and marketing. Increased attention was given to developing a knowledge-based

[8] For an assessment of the early phase of the privatization program, 1983–1990, see Adam and Cavendish (1995).

economy and, subsequently, to services, including ICT services, as a new source of economic growth.

A key objective of the MSC is to lay the foundation for Malaysia to become a global and regional leader in ICT development and applications. Envisaged as a "multimedia utopia," the MSC is located in a corridor of 75 square kilometers leading to Kuala Lumpur International Airport (KLIA) in Sepang, and containing the two new cities of Putrajaya (the administrative center of the federal government) and Cyberjaya (which houses ICT companies, with intelligent buildings and urban systems).[9] The MSC's focus is on the conceptualization, design, testing, production, and distribution of advanced ICT applications.[10]

To attract international companies into the enclave the MSC contains hard infrastructure (such as fiber-optic telecommunications networks and modern transportation networks) and soft infrastructure, packaged with incentives and a conducive legal and regulatory environment. Again, as an example of the "cluster of reforms" approach, four cyberlaws were enacted in 1997: the Digital Signature Act, the Copyright Act (Amendment), the Computer Crimes Act, and the Telemedicine Act. They are an integral part of the new policy, which facilitated their passage through the legislature.

The fiscal and nonfiscal incentives package for MSC companies is worth an examination, as it illustrates both the old-style industrial policy instruments used throughout Malaysia's push towards higher industrialization as well as a new style of operation based on simplicity and marketability, rather than an obtrusive development ideology. Given Malaysia's generally low taxes, it is not clear what correctives are being applied through granting extraordinarily favorable fiscal incentives; they may simply reflect a race to the bottom in a tough neighborhood. With regard to fiscal incentives, the MSC-status companies are granted a 5-year exemption from income tax, renewable to 10 years, or a 100 percent Investment Tax Allowance (ITA) on new investments made in MSC cybercities. Imports of multimedia equipment are duty free. R&D grants are granted to local small and medium-size enterprises (SMEs). MSC-status companies exporting multimedia products manufactured in Malaysia using dutiable components are eligible for a refund on the duty paid on the re-exported components. The nonfinancial incentives granted to MSC-status companies allow them to employ foreign knowledge workers without restriction, the companies can be wholly foreign owned, and they are also allowed to source capital globally and receive exemptions by the Controller of Foreign Exchange from exchange control requirements. In return, to enjoy MSC status, companies have to meet criteria: they must be providers or heavy users of multimedia products and services, employ a substantial number of knowledge workers, and they have to specify how they will transfer technology and/or knowledge to Malaysia, or otherwise

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[9] For a summary and highlights of the MSC see Rani (2007).

[10] The MSC has six flagship applications: smart schools, multipurpose smart cards, e-government, worldwide manufacturing web, borderless marketing, and telemedicine.

contribute to the development of the MSC and the Malaysian economy. Products and services can be from anywhere in the multimedia value chain—that is, content, distribution, or user environment. In addition, several institutions support the MSC. A Multimedia Development Corporation (MDC) was established in 1996. The MDC implements and monitors the MSC program, processes the applications for MSC status, and advises the government on MSC laws and policies. A MSC International Advisory Panel (IAP) made up of experts and corporate leaders from the global community and Malaysia was instituted to provide advice on the MSC.

Progress in attracting investment in the MSC and in developing the flagship applications is noticeable (table 9). By end-2000, 429 companies had been granted MSC status, of which 274 were Malaysian-owned (EPU, 2001a). Most companies were involved in software development for engineering and specialized applications (70). Others were involved in e-commerce services/solutions (44), software development for business applications (56), and Internet-based business application services (37). Europe (50 companies), the United States (27 companies) and Singapore were the top three countries invested in the MSC. A fiber-optic backbone network, covering 360 kilometers, was completed over the 1996–2000 period.

More than 27,000 new jobs were created in the MSC by 2005, and about RM 5.11 billion was invested. The number of MSC-status companies increased to 1,421 firms (EPU, 2005). Investment by end-2004 had reached RM 5.11 billion. There were 349 foreign-owned companies. The MSC entered its second phase over the 2001–05 period, and cybercity status was granted to Bayan Lepas in Penang and the Kulim Hi-Tech Park in Kedah in the north.

Table 9: Selected MSC Indicators, 2001–10

Category	2001	2005	2010 [a]
MSC-status companies (number)[b]	621	1,421	4,000
Locally owned	410	1,033	—
Foreign owned	198	349	—
Joint venture (50–50)	13	39	—
Job creation (number)[b]	14,438	27,288[b]	100,000
Knowledge workers	12,169	24,252[b]	—
Others	2,269	3,036[b]	—
Investment (RM billion)	3.16	5.11[b]	12
Revenue (RM billion)	—	7.21[b]	69
Exports (RM billion)	—	1.57[b]	2.5
R&D expenditure (RM million)	—	670[b]	1,000
IPs registered (number)	—	119[b]	1,400

Source: EPU (2005).

Notes:
— Not available.
a. Estimates.
b. As of December 2004.

However, while the first phase target of 500 companies was exceeded, there were still gaps in content development. The demand for offshore and shared services and outsourcing has increased; by 2005 there were more than 550 companies providing about 12,000 jobs in the MSC in these areas. Progress in multimedia applications for the flagship applications has been steady; more than 300 companies participated in the development of multimedia applications. The MSC attracted international interest and established a business presence in the cities of Jeddah in Saudi Arabia and Dalian in China. Progress in other flagship areas has been slower, and is the subject of intense government and industry scrutiny and strategizing.

4. Political System and Leadership

Alliance, *Barisan Nasional*, and Ethnicity

An understanding of the politics and political system is helpful in understanding the nature of leadership and policy making in Malaysia. Ethnic considerations have and continue to dominate politics. Dealing with ethnicity issues has been a central task for leadership, and the Malaysian case study presents an example of how a leadership has dealt with economic efficiency, growth, and nation building in an ethnically divided community.

In attempting to understand leadership, it is not sufficient to consider only the personal traits of leaders. An examination of the access of leaders and their interaction with followers is also essential. Traditional values associated with Malay leadership include the need to avoid conflict, an emphasis on traditional courtesy and good manners, wide consultation, and the avoidance of direct confrontation. A test of leadership is whether followers trust a leader sufficiently to follow him when he embarks on a difficult and new course of action. A leader, therefore, needs to instill loyalty, provide tangible material benefits, and to stamp his legitimacy. However, Mahathir, who was Prime Minister during much of the period covered by this case study, attempted to straddle both traditions and once remarked, "You have to lead. You should be sensitive to what your followers think. But if you do exactly what they want you're not a leader."[11]

The specific performance requirements for Malaysian leaders are complex and reflect the interaction between communal traditions, the new ethnic politics, the distribution of rents from Malaysia's vast natural resources, and the growth imperative in an increasingly competitive international economy. This is not to suggest that personal traits do not matter. The four desirable personal qualifications are that the leader should fight for the Malay cause, should not be aloof, should have style, and be of aristocratic birth (Milne and Mauzy, 2006).[12] It

[11] Quoted in Milne and Mauzy (2006, p. 3).

[12] Malaysia's first three Prime Ministers, unlike Mahathir Mohamed, were all of noble birth, but a common feature of all four leaders was that none of them was entirely Malay. See Yong (2004) for

is interesting that tensions within the leadership system have stemmed from factors related to the last of these, as seen in Mahathir's disagreements with the aristocratic leadership group during the 1980s and 1990s.

The leadership style and its methods, especially in the pre-1969 phase, depended crucially on the functioning of a coalition government. Inter-elite bargaining was the basis for exercising political leadership. The Alliance, originally formed in 1952 between the United Malay National Organization (UMNO) and the Malaysian Chinese Association (MCA) and including the Malaysian Indian Congress in 1954, depended on a coalition of ethnically based parties, as did the *Barisan Nasional* (National Front), its successor, which was established in 1974. The leader of the coalition became the Prime Minister, as well as the head of UMNO, which has always been the dominant party in the coalition. The head of UMNO also controlled the process of inter-elite bargaining. The essence of the system was described by one astute observer, Gordon Means, in a manner that is as valid today as it was in describing the early leadership of the country.[13]

Consensus Building, Conflict Management, and Executive Powers

As mentioned earlier, concerns over inter-ethnic conflicts remain central to the Malaysian growth and development experience. Increasingly, however, a class perspective has begun to replace the ethnic perspective, although lately a hybrid approach by both proponents of ethnic and class approaches and of "hyphenating" class and ethnicity has been the preferred approach (Teik, 1995).[14]

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an overview of the four key Malaysian leaders. Tunku Abdul Rahman had Shan-Thai parentage, Razak a Bugis had Indonesian background, Hussin's family had Turkish components, and Mahathir's background included Indian family members. All of them started as administrators in the government bureaucracy. Abdul Rahman worked well with the British during the transition to independence and has the accolade of being the "Father of Malaysia." Abdullah Badawi succeeded Mahathir Mohamed as Prime Minister in October 2003. Abdullah Badawi sought a fresh mandate in the general elections in 2004 and the *Barisan Nasional* won 94 percent of the parliamentary seats (198 out of 219) and 64.4 percent of the popular vote. See Gomez (2006) for an assessment of the 2004 general elections. For some views on the differences in leadership styles between Mahathir Mohamed and Abdullah Badawi see Tan (2007).

[13] "Each Prime Minister developed his own style of leadership, which required forceful leadership of his own party while also preserving his capacity to act as arbiter between the rival claims of ethnically mobilized coalition partners. Any leader had to give first priority to his leadership of the Malay community so as to retain support from the UMNO party machine and the rank and file of Malay voters. At the same time, the leader had to sustain an image of being a fair and conciliatory national leader who could listen to diverse political views and resolve often intense political differences that were being articulated, sometimes with militant tactics, by second-level ethnic elites with the government's coalition. Without inter-ethnic accommodation and bonds of elite empathy across ethnic boundaries, the minimum of consensus necessary to sustain both public and parliamentary support could rapidly erode, placing the government in jeopardy and thereby creating an extremely volatile political crisis. Each Prime Minister developed his own techniques and leadership style to resolve these seemingly contradictory roles and objectives." (Means, 1991, p. 284).

[14] See Jomo (1988) for example of a class-based approach to Malaysian politics.

Generally, episodes of inter-ethnic conflict have been few and far between in post–World War II Malaysia. The May 13th inter-ethnic clashes, when more 100 people died, was the most traumatic post-independence incident, and had far-reaching repercussions on the political, economic, and social environment in Malaysia.

As mentioned earlier the Malaysian experience provides an example of a workable approach to building consensus in a fractious society divided by race, religion, and culture. This has been characterized as "consotionalism," or inter-elite bargaining and accommodation, between the three ethnic communities. Although it has been argued that the May 13th, 1969 ethnic clashes undermined consotionalism, elements of it survived in the post-1969 growth phase of the economy.

The early experiments in containing inter-ethnic animosities started in the early post–World War II years. In late December 1948, 21 community leaders had an informal meeting with Dato Onn Jaafar in Johore Bahru, where a decision was made to form a group to examine the sources of ethnic conflict and to find ways to overcome it (Mauzy, 1983). A Communities Liaison Committee (CLC) was then formed on January 10, 1949, consisting of six Malay members, six Chinese, and one member each from the Indian, Ceylonese, and Eurasian and European communities. Many Malays treated the CLC with apprehension. The CLC issued two reports over the 1949–50 period covering political aims, citizenship, and steps to improve the economic position of the Malays. The CLC provided evidence that the top leaders were aware of the desirability of inter-ethnic compromise, and also of the usefulness of "conducting sensitive bargaining by semi-secret negotiations" and the "principle of inter-ethnic co-operation to improve the economic position of the Malays was accepted" (Mauzy, 1983).

The formation of the Alliance party to contest the Kuala Lumpur Municipal Elections in 1952 was a milestone in the experiment, with agreement on workable political arrangements and a framework within which to build consensus. UMNO and the MCA each fielded six candidates and the alliance won 9 of 12 seats. On August 23, 1953, the Alliance was officially launched with Tunku Abdul Rahman as its leader, a Liaison Committee was formed, and in September 1954 a 30-member National Council was formed. On October 17, 1954, the Malayan Indian Congress (MIC) joined the Alliance. However, the racial riots in 1969 led to a search for a new form of political governance. Coalition building led to the formation of the *Barisan Nasional* on June 1, 1974, which in many ways is Alliance writ large. The Alliance coalition-building scheme devised by Abdul Razak was to aim for a widely representative and consensual government. A National Consultative Council (NCC) was formed with some members drawn from the opposition. The NCC, with the principles of "representativeness, confidentiality, and consensus," assessed the ethnic clashes and the nature and extent of discontentment amongst the Malays, and then suggested measures to ameliorate the situation.

With the approach of 1990, the terminal year of the NEP, the government set up the National Economic Consultative Council (NECC) with *Bumiputera* and non-*Bumiputera* members, to consider what would replace the NEP. Some of the NECC's recommendations were incorporated in the National Development Policy (NDP) that replaced the NEP, and in the Second Outline Perspective Plan (OPP2). Consensus building was generally helped by focusing on development plans, statements of ideology, and on visions. The five-year development plans, the mid-term reviews of the five-year plans, and the long-term outline perspective plans (*Rukunegara* and Vision 2020) were all part of the effort to provide the sources and framework for debates, discussions, and the building of consensus.[15] Moreover, legislation that removed several sensitive issues from political debate provided some measure of discipline and stability.

As summarized above, Malaysia has developed a political system that has been characterized as "an elite accommodation system." The Alliance/*Barisan Nasional* system of elite cooperation, or consotionalism, differed from the "ideal" model (Milne and Mauzy, 1999). Consotionalism, for example, includes the principle of proportionality (that is, the benefits received by groups or parties should be proportional to their numbers.[16] Under the Alliance/*Barisan Nasional* system the workings of the system did meet one ideal of consotionalism closely; followers, generally, did follow their leaders. UMNO, as the dominant component of the consotional system, tends to propose and carry through most major items of policy and often rejects proposals from other members of the coalition, a practice described as "hegemonic consotionalism." Consotionalism depended on the capacity of the key political elites from each community to reach accommodative solutions to key public issues.

In the Alliance, sensitive and contentious issues were resolved within the governing Councils by the representatives of the three communal parties. Demographic, political, and economic changes have, however, eroded the Malaysian elite accommodation system over the years. The system seems to have been terminated with the imposition of Emergency Rule following the May 13, 1969 racial clashes. *Rukunegara*, the national ideology, was launched and essentially it asserted that the fundamental agreements that had been struck earlier through inter-ethnic bargaining, the "Racial Bargain," could not be challenged. Amendments on the sensitive ethnic issues were made in the Constitution, including sections on rights, citizenship, Malay special rights, status, and powers of the Malay rulers, status of Islam, and the status of Malay as the sole national language. The amendments also gave powers to the Yang Di-

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[15] *Rukunegara* (the national ideology) was launched on August 31, 1970, and contained the five principles of belief in God, loyalty to King and Country, upholding the constitution, rule of law, and good behavior and morality.

[16] This principle of proportionality was implemented in the post-1969 period under the NEP, when employment restructuring at all levels was designed to reflect the ethnic composition of the population.

Pertuan Agung, the King, to reserve academic places in institutions of higher learning for Malays in areas where they were disproportionately few in number. The NEP was then launched in July 1971, when the Second Malaysia Plan was presented to Parliament.

To supplement these changes the party system was remodeled to co-opt other political parties into an enlarged Alliance—the *Barisan Nasional*. The role of the party leader was different under the new coalition: the leader became less accessible and could deal with the leaders of the component parties on a one-on-one basis, playing off one against the other, thus enhancing the power of the Prime Minister (Milne and Mauzy, 2006). These political and economic changes enhanced the powers of the executive in the post-1969 period.[17] When there was inter-elite bargaining, it revolved around the role of the Prime Minister "who dispensed favors, patronage, and occasional policy concessions in a web of bilateral arrangements and agreements" (Means, 1991, p. 286). The new system of a "dyadic structure of elite bargaining" enhanced executive powers and a sharp growth in patronage.

Leadership within UMNO, the dominant party in the ruling *Barisan Nasional* coalition, tended to accept the system of granting some degree of local autonomy. Followers assumed that national UMNO leaders would be responsible to the rank-and-file membership of the party. UMNO Youth and Wanita UMNO (women's wing) could take, as pressure groups, some independent stands, with the former usually taking a stronger line on communal issues and against any compromises and concessions to non-Malays that might diminish Malay rights or advantage. Following the split in UMNO in 1987, the newly formed UMNO Baru formulated a new constitution that emphasized leadership from the top, strong leaders, and "party unity," and these "authoritarian leadership patterns derived in part from the logic of ethnic political mobilization and the processes of inter-elite bargaining, especially the prevailing style operating within the BN" (Means, 1991, p. 288).

The increasing size and complexity of the executive have also enhanced the role of the Prime Minister. He combines multiple leadership roles as leader of the Malays (UMNO), *Barisan Nasional*, government, and the nation. Opportunities for the disbursement of patronage and privilege have also expanded, but the pattern of patronage has been changing. Under Abdul Rahman, patronage was

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[17] "The *Barisan Nasional* Council was transformed into an institution of ritualized confirmation for political agreements worked out by the Prime Minister. The Cabinet became much more restrained in its discussion of policy proposals. Cabinet meetings became the occasion for the Prime Minister's policy pronouncements and political exhortation, but little opportunity was provided for dissenting views or consideration of policy alternatives. The Cabinet was the place to raise issues of administrative jurisdiction and inter-agency coordination but not to debate the major priorities and policies initiated by the Prime Minister. When public protests became organized against some policy initiatives, the Cabinet then could become a venue for making partial adjustments and corrections to policy so as to placate protesters. But elite bargaining in the Cabinet was minimized and no longer preceded the formulation of fundamental policy objectives" (Means, 1991, p. 286).

dispensed to a close circle of friends through informal agreements, but the patronage system under Mahathir Mohamed grew substantially, and included layers of intermediaries (Means, 1991). Concerns with the rise of power centers also have led to the concentration of power in the hands of the Prime Minister, and Cabinet reshufflings have sometimes been used to slow or erode the growth of new centers of power.

The rise in the powers of the executive, and the role and power of the Prime Minister's leadership, can be illustrated with four cases over the period 1983–92, when Mahathir Mohamed was engaged in contests for power.[18] The first contest in 1983 involved the monarchy, the Agung, and the state's rulers, to ensure that their powers were defined sharply. In this case, constitutional amendments were made to reduce the royal powers in order to delay assent to a bill that had been enacted by Parliament. The second case, in 1998, involved the removal of the Lord President of the Supreme Court of Malaysia. Five more Supreme Court judges were also suspended and two were dismissed.[19] The third case, which culminated with the 1987 UMNO General Assembly, was the contest to retain control of UMNO. This led to an UMNO split, the formation of a new political party, and a new UMNO, renamed "UMNO Baru." Following Mahathir's victory at the Assembly, UMNO's constitution was amended to enhance the power of the UMNO president.[20] The fourth case in 1992 involved a contest over royal immunity from the rule of law.

New Political Developments

A major shock was inflicted on *Barisan Nasional* by the twelfth general elections held on March 8, 2008. The sizable gains that the *Barisan Nasional* made in the 2004 general elections were dissipated. Not only did it lose its two-thirds majority in the national parliament, but also it lost control of the four states of Kedah, Penang, Perak, and Selangor, and failed to win back Kelantan, where Parti Islam Malaysia (PAS) had only a one-seat majority in the state government. In many constituencies where it was successful the *Barisan Nasional's* margin of victory was smaller than before. In gaining control over the five states and

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[18] For the cases of power contests and crises, see Lee (1995), Means (1991), Teik (1995), and Milne and Mauzy (1999).

[19] For views on the controversy and the outcome see Abas and Das (1989). See also Addruse (1990) and Lee (1995). From 1986, Mahathir began to criticize the judiciary following a number of cases that were decided against the government and UMNO. In the case against the sacked Finance Minister and prominent UMNO member Anwar Ibrahim in 1999, Anwar was quoted as saying: "The Prime Minister uses the judicial system as a tool to exert political pressure. All the instruments of government, including the Attorney General's office, the police, and indeed the judiciary are under the Prime Minister's thumb" (Anwar Ibrahim, Court Deposition, April 14, 1999, available at: http://mindspring.wordpress.com/2008/06/24/what-drives-a-person-to-leadership-case-1-anwar-ibrahim/.

[20] The UMNO crisis started in 1987 when Razaleigh and Musa Hitam joined forces to oppose Mahathir. After their unsuccessful attempt, they rejoined UMNO.

metropolitan areas, the opposition now is in control of over 45 percent of the economy in terms of GDP.

The *Barisan Nasional* now holds 140 of 222 parliamentary seats, giving it a more than ample majority of 64 percent of the total seats compared to 91 percent in 2004. It won 50.6 percent of the popular vote, compared to 63 percent in 2004. The Malaysian Chinese Association (MCA) won only 15 parliamentary seats, the Malaysian Indian Congress (MIC) 3, and Gerakan 2 seats, and it lost control of Penang. Support for the UMNO by the Malays has also weakened. Sabah and Sarawak remained solidly behind the *Barisan Nasional*, which won practically all seats.

The opposition parties made grand advances. The Democratic Action Party (DAP), Parti Keadilan Rakyat (PKR), and PAS made substantial gains and the opposition coalition now is in control of Kedah, Penang, Perak, and Selangor. The opposition, including the independents, now number 78, or 36 percent of parliamentary seats, and garnered 47.2 percent of the popular vote. The largest share of this vote was gained by PKR (18.4 percent), followed by DAP (14 percent) and PAS (13.7 percent).

An outstanding feature of the elections was the unexpectedly massive swing in voting away from the *Barisan Nasional*. It had severely underestimated the extent and depth of discontent among the electorate and has misread public sentiment. On hindsight, it appears that the disgruntlement of a subset of the Indian community (which led to street demonstrations), the public airing of weaknesses in the judicial system and interference with the appointment of senior judges by the political leadership, inflation (especially of food prices), the misbehavior of politicians, and increasing insecurity and corruption were sufficiently toxic to swing the voters against *Barisan Nasional*.

The initial assessment suggests that ethnic factors played a smaller role in the 2008 elections than before. Fewer Malays voted for UMNO, shifting to the DAP and other opposition parties. Moreover, Chinese voters deserted the MCA in large numbers, and more Indians have voted for PKR than expected originally. UMNO was able to attract less than one third of the total votes cast (29.6 percent).

The four new states governed by the coalition of opposition parties are likely to attempt to present themselves, especially to foreign governments and overseas interests, as concrete alternatives. One likely outcome, if they are successful in burying their differences, would be the attempt by the opposition to adopt a common approach to the governance of the states under their control and the adoption of common policies. There could, therefore, be a divergence between federal and state policies. A key example of the possible consequences of such a divergence is the acrimony surrounding recent declarations by the opposition parties that implementation of the NEP is responsible for cronyism and corruption in Malaysia today, and therefore it should be abandoned.

As state governments rely on federal financing for budgetary spending, a rational approach to reducing their dependence on the federal government would be to open up and liberalize the state economy for faster growth, while seeking greater amounts of external capital, including more FDI. These opposition states are also likely to test and stretch their powers as much as they can under the constitution. The potential for disagreements between the federal and state governments is high; it remains to be seen how these disagreements will be sorted out and their fallout contained.

Although the *Barisan Nasional* has had long experience in dealing with recalcitrant states, such as Kelantan (and previously Terengganu), dealing now with four additional states under the opposition is uncharted territory. A period of adjustment for both the *Barisan Nasional* and opposition is inevitable as the country eases itself into this new phase of political and economic development. The general election results have triggered a reevaluation within the *Barisan Nasional*, but it has also encouraged dissension. Pressures for changes in political leadership have mounted, including calls for Prime Minister Abdullah Badawi to resign. Hence, leadership changes are expected to mount within the short term and probably within the next year. It remains to be seen whether mechanisms for economic decision making and policy implementation are strong enough to meet the twin challenges of continuing to promote steady growth with equity and cope with globalization.

5. Policy Design and Implementation Issues

The Malaysian growth story, like that of other developing countries, can be viewed as a narrative of the structural transformation of a predominant agricultural economy to a more industrialized economy, and then to attempts to transform it even further in the latter part of the 1990s towards a knowledge-based economy. Initially, primary commodities—rubber, tin and, later, palm oil—dominated the economy. Subsequently, the export-led growth of labor-intensive manufactured products sustained economic growth. However, with rising competition from emerging economies, especially China, the prospects for long-term growth looked bleaker, and the pressures for further structural transformation increased. A characteristic pattern of economic development policies in Malaysia is the underlying concern with economic diversification, with the ebbs and flows of official interest in promoting diversification determined strongly by the phase of the business cycle. Slowdowns and recessions have provided powerful impetus to official policies for economic growth through diversification. At the current juncture of Malaysian growth, given the post–Asian crisis slowdown that has largely persisted, there is a renewed search for structural transformation to reach a higher, sustainable growth plane.

In this section, we consider the role of policies, the design of policies, and implementation issues. Underlying this section is the issue of the role of government in structural transformation and the details of the government's role in the process of structural transformation. We will consider the nature of policy initiation, factors affecting the design of policy, the implementation machinery, and the technical and financial underpinnings.

The post-independence leaders and policy makers in Malaysia inherited institutions that were the legacy of more than 100 years of British colonial rule and appeared to be better functioning and stronger than in other developing countries. Due to the political pressures mentioned above, the executive and legislative institutions came under stress, and the centralization of powers and the strengthening of the executive gained momentum. However, the parliamentary system was relatively intact. With the exception of Emergency Rule for a period of almost two years after the outbreak of the 1969 racial riots, parliamentary democracy has prevailed. Nevertheless, the sacking of the Lord President and two senior Supreme Court judges in 1988 marked an important milestone towards strengthening the executive arm of the government.

Sources of Policy Initiatives

Who initiated Malaysia's economic policies? To pinpoint the sources of policies, and of changes to policies, it is necessary to look at the institutional machinery. At the start, it is helpful to make a distinction between the federal government, state government, the nonfinancial public enterprises, the government-linked companies (GLCs), and the private sector. These are the main sources of policy origination. The federal government has the authority and is, therefore, the source of macroeconomic policies. The three centers for macroeconomic policy initiatives are the EPU in the Prime Minister's Department, the Ministry of Finance (MOF) or the Treasury, and Bank Negara Malaysia, the central bank. EPU is responsible for the formulation of the five-year development plans and the mid-term reviews of the five-year plans. It is also tasked with preparing the long-term development plans, that is, the outline perspective plans that cover a period of 15 or 20 years. EPU also initiates specific studies or master plans—the *Privatization Master Plan*, for example—and it has also just completed a master plan for human resources development. Monetary policy and exchange rate policy comes under the purview of the Bank Negara Malaysia (BNM). BNM has overall responsibility for the development of commercial banking and the insurance industry in Malaysia. It formulates and monitors the long-term Financial Sector Master Plan. Fiscal policy is under the purview of the MOF, and this covers the areas of taxation, operating and development expenditures, and the preparation of the annual budget. BNM comes under the supervision of MOF.

Macroeconomic policy initiatives are usually coordinated by the EPU, BNM, and MOF. The agencies responsible for the development of the various sectors

are also involved, but the lead is taken by the three key central agencies. There is an Inter-Agency Planning Group (IAPG) with the three central agencies as members, supplemented by a selected number of ministries and departments. The IAPG is usually activated for the preparation of the five-year plans, and when there are matters that involve policy making in between the planning cycles. The EPU serves as the Secretariat to the IAPG. Technical Working Groups (TWGs) for the five-year plans provide the technical support.

There are other sources of policy initiatives within the federal government. A National Development Planning Committee (NDPC), with the EPU as Secretariat, is responsible for considering the five-year development plans up to the level of senior officials and technocrats. Papers that seek policy decisions from the NDPC are prepared by the EPU. The NDPC also considers policy matters or issues that are submitted for its consideration *through* the EPU. The central agencies of the federal government are members. The Chief Secretary to the Government is the Chairman of the NDPC. The MOF and the BNM have their own committees that consider policy matters under their purview, and they take the lead as Chairman and Secretariat to their respective Committees. The BNM usually submits policy and other matters for decision to the Minister of Finance. Regular briefings given to the Minister and other senior officials of the MOF provide opportunities for discussing policy matters and developments in the financial sector.

The Cabinet is the final arbiter on policy matters. Various ministries and government departments submit policy papers for the consideration of the Cabinet, and these are presented by the respective ministers. The Cabinet papers are prepared with the prior consultation of the relevant ministries and departments, and their views are incorporated in the Cabinet papers. Where there are dissenting views on policies that cannot be resolved at the level of the officials, these policy matters are tabled for the Cabinet to decide. If the Cabinet is unable to decide on the policy matter it can instruct and direct the relevant minister and the initiating agency to reconsider the matter and resubmit it to the Cabinet when it has completed its task.

There are also several councils, committees, and task forces of the Cabinet that have initiation and vetting responsibilities in specific areas of economic policy. There is, for example, a Cabinet Committee on Competitiveness, and a newly established Committee to consider high-impact investment projects under the Chairmanship of the Deputy Prime Minister. Recently, a National Implementation Task Force (NITF), with the Prime Minister as the Chairman, was established to monitor and accelerate the implementation of programs under the Ninth Malaysia Plan, 2006–10. The NITF also decides on policies when it considers the various development programs of the government agencies.

Two other groups linked to the federal government can also be the source of policy initiatives, namely the nonfinancial public enterprises (NFPEs) and the GLCs. NFPEs and GLCs are agencies operating in the corporate environment in

which the government has equity interests. Under the Eighth Malaysia Plan, 2001–05, 37 enterprises were included in the list of NFPEs, and this was based on government holding equity of at least 51 percent and a turnover value of at least RM 100 million (EPU, 2001a).[21] Enterprises with large borrowing needs and capital expenditures were also grouped under the list of NFPEs. Some of the companies classified as NFPEs were listed on the Kuala Lumpur Stock Exchange. The development expenditure of the NFPEs amounted to about RM 119.5 billion or 53.6 percent of the total public sector development expenditure. The NFPEs are an important source of financing for the federal government. Under the Ninth Malaysia Plan, for example, the current surplus of the NFPEs is expected to increase from RM 63.8 billion in 2005 to RM 77.7 billion in 2010.

While the federal government agencies, individually or collectively, are the major initiators of policies and policy changes, there are nongovernment sources of policies. The private sector is usually engaged in the formulation of policies. With the greater emphasis on the role of the private sector in development, many opportunities have been provided to businesses to initiate policy discussion and to recommend changes in policies. Representatives of private associations and commercial groups as well as corporate leaders participate in these groups. The Budget Dialogue between the Minister of Finance, senior staff, and the corporate leaders is held every year. Written contributions from the private sector with their views and recommendations on measures for the budget are solicited actively. The MITI also holds an annual dialogue with the private sector, focusing on industrial policies. Apart from these two examples, there is an extensive list of committees, task forces, and working groups that is led by various ministries and departments where the private sector is invited to discuss new policy ideas, or to review and refine existing policies.

Independent and semi-independent groups from the universities and think tanks are another group in the policy-making loop. The three leading public universities are the University of Malaya, National University, and Science University. The three leading think tanks are the Malaysian Institute of Economic Research (MIER), Institute of Strategic and International Studies (ISIS), and the Asia Leadership Institute (ASLI). The ISIS, with partial funding from the government, conducts work for the government, especially on strategic long-term policy issues. The MIER and ISIS have been commissioned by the government to conduct studies and to make policy recommendations.[22] Conferences, seminars, and workshops held by these think tanks provide platforms for the exchange of ideas and feedback on the impact of economic policies on the economy.

International agencies have been the source of significant policy ideas. The World Bank, International Monetary Fund (IMF), and the Asian Development

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[21] According to the Eighth Plan originally there were 28 NFPEs. The current list excludes 10 agencies that were privatized during 1996–99 and includes 19 new enterprises.

[22] ISIS, for example, led the preparation of the Knowledge-Based Economy Master Plan.

Bank (ADB) have been the three leading agencies that have engaged the government on policy matters. World Bank, IMF, and, to a lesser extent, ADB missions to the country have been occasions for the review of policies and for the consideration of new policies. The World Bank's work on poverty in Malaysia, for example, has been an important source of policy ideas on poverty alleviation. While borrowings from the World Bank have been relatively low, the Bank has been an important source of policy ideas.

It is usually impossible to identify the footprints of the numerous actors involved in the design and refinement of economic policies. Policy ideas, in particular, emanate from official and unofficial sources, so it is not until an organizational unit is given a mandate to initiate the policy that the actors become visible. A distinction should also be made between the sources/initiators with key roles and others that expand or refined the initial policy ideas. Usually, there is an amalgamation of initiators, feeding on each other through interaction, which leads to the formulation of policy. A few examples could illustrate these points.

Prime Minister Mahathir initiated a number of policies. The privatization policy was considered and launched in Malaysia at a time when Thatcher was promoting privatization in the United Kingdom. Prime Minister Mahathir could be considered the source of the privatization idea, but this was an example of a policy that was non-Malaysian in origin.[23] When the government under Mahathir agreed on the privatization policy the details of the policy were left to be worked out by the EPU, and for this the United Kingdom's experience was used extensively, as there was little experience on privatization in the Asian economies. The work on privatization culminated in the publication of the *Guidelines on Privatization* in 1992. Similarly, the Look East Policy, the development of heavy industries including the national car, and the MSC were all initiated and given a push by Mahathir, who took the lead and was involved in sustaining the policy initiatives.

The nature and background to the launching of policies were varied. A different approach was adopted for distributive policies. The NEP announcement was made by Tun Abdul Razak, the Prime Minister, following the racial clashes in May 1969. The details of the NEP were subsequently expanded in the Second Malaysia Plan, when it was published in 1971. The debates and discussions on the NEP were initiated by the NCC, a group formed during the emergency following the racial clashes, and it consisted of a wide range of individuals representing various interest groups. When the NEP ended in 1990, the government initiated the NDP, and before that, it set up the NOCC. A cross-section of interests was also represented in the NOCC and the deliberations on policies to succeed the NEP were led by the NOCC for a period of about a year.

[23] Nevertheless, there were home-grown antecedents to the privatization policy. The NEP had stated that the government would sell enterprises to *Bumiputera* entrepreneurs when they had the capacity to manage the enterprises.

There was no formal effort to debate the new policy initiatives. Public announcements and elaborations of the policies were made on various occasions, such as at press interviews, conferences, seminars, and workshops. When the Prime Minister and other ministers were interviewed by the media, they used these opportunities to explain the policies. Critics of the various policies voiced their opinions and there was no systematic effort to suppress dissenting views on the policies.

The policies on privatization and heavy industries, especially on the national car, attracted much attention, as it was felt that there would be adverse repercussions on the economy.[24] It was argued that Malaysia had no comparative advantage to develop the heavy industries and that it could not compete with other low-cost producers of, for example, steel and petrochemicals. The privatization policy, for example, was first enunciated in 1983 by Mahathir and this was followed by the *Guidelines on Privatization* published by the EPU in 1985. The policy was subsequently expanded and updated when the *Privatization Master Plan* was published in February 1991. The MSC, which was launched in 1996, was initiated in the same manner, that is, there was no preset program for a debate on the pros and cons of the MSC. The details of the MSC were elaborated on various occasions through seminars and interviews, and the public was informed and educated through these channels.

How was support for the policies built? Two general approaches to building support can be identified. *First*, support was built through the wide dissemination of information on the rationale, objectives, and details of the programs for each of the policies. Interviews, conferences, and seminars were the channels that were utilized by the politicians and technocrats for building support for the policies. Politicians usually focused on the broad elements of the policies whereas bureaucrats elaborated the policies and specific measures and the programs and projects that accompanied the policies.[25] Grassroots support was built by visits to parliamentary constituencies and to the branch offices of the ruling political parties. At the national level, political support was mustered by the *Barisan Nasional* at the annual assemblies of each of the ethnic-based parties to the coalition. Delegates to the assemblies usually voiced their opinions on the policies, especially on the implementation of the policies. The technocrats attending the assemblies provided inputs to enable the political leaders to respond to queries. The Cabinet was also actively involved in lobbying for policies, and dissenting views on economic policies were then considered and resolved by the Cabinet.

The recent events surrounding a reexamination of the National Automobile Policy (NAP) highlight the approaches used to mobilize support, and to focus and resolve dissent in the policy-making apparatus. Under the new leadership of Prime Minister Ahmad Badawi, who succeeded Mahathir, a reassessment of the

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[24] See for example Jomo (1995).

[25] Mahathir personally picked Kelang Container Terminal (KCT) for the first privatization.

automotive policy (which focused on the national car) was initiated. Changes were made to the Board of Directors and the CEO of Proton Holding Berhad, following Mahathir's departure. These were criticized by Mahathir. The issuance of Approved Permits (APs) is a policy instrument for the importation of motor cars from overseas. It was contended by Mahathir, who was also the Adviser to Proton Holdings Berhad, that the excessive issuance of APs to a handful of selected *Bumiputera* had undermined the viability of the national car, as the number of imported vehicles had increased substantially. Also, the sale at drastically reduced prices of Proton's interests in an Italian company producing motorcycles was criticized by Mahathir Mohamed. The MITI came under heavy criticism on all of these points. Prime Minister Badawi left it to the MITI to deal with the AP issue and initiate a review of the national car policy, and to come out with a new policy.

The Cabinet was involved in deliberations on the needed AP scheme reforms and the new NAP. The outcome was the formulation of an NAP that had the support of the Cabinet. It argued for speedier liberalization of the automotive industry and an initial tightening of the issuing process of APs, and eventually their elimination. Sensitivities attached to these decisions were due mainly to Mahathir's close association with the national car project, as it was often argued that he saw the shifts in policy as undermining his achievements and legacy. It was also sensitive because a large number of *Bumiputera* vendors (for example, those who supplied parts to the national car) were threatened by the proposed liberalization.

Management of the privatization policy offers another example. Labor interests were opposed to the privatization policy because they were convinced that they would lose out when GOEs and agencies were privatized.[26] By 1990, about 54,000 employees had been transferred to the private sector. The trades unions anticipated that, with the emphasis on efficiency, the privatized entities would shrink and workers would suffer a reduction in lifetime benefits. Opposition from trades unions gathered momentum when the first moves to privatize agencies were announced. The Government responded by slowing the process, and by making a strong effort in the early privatizations to address the concerns of the affected workers.

The privatization of the Kelang Container Terminal (KCT) in 1985 was the first project, and it provided useful lessons on garnering the support of labor interests. The early negotiations with the union were protracted. The Government's final wage and benefits package granted generous options and protection for employees affected by privatization. Job security was provided for five years, and employees had the option of retiring early, or staying on with the Kelang Port Authority (KPA) on terms no less favorable than they had enjoyed previously.[27] Essentially, employees who opted to join the privatized company

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[26] For an account of labor and privatization issues see Kuppusamy (1995).

[27] See Adam and Cavendish (1995) on the privatization of KCT.

could retire with immediate payments of benefits. For those employees who opted to remain with the private entity, they were offered the choice of continuing with the government's conditions of service or choosing the new privatized scheme, which included ownership of shares in the new company and bonuses based on performance. Most employees chose the privatized scheme. The Pensions Act 1980 was amended to preserve accumulated civil service pension rights. Still, garnering total labor support at all levels proved to be difficult in subsequent privatizations.[28] Labor support for privatization was benchmarked on replicating the favorable terms extended during the privatization of KCT.

Second, support for policies was built by setting up specific institutions that were responsible for implementing and monitoring the policies. Institutions play a key part in providing the support and implementation of economic policies. Without an effective and well functioning institutional regime, even well thought–out policies will be ineffective and economic growth will stall. The major institutions were established at the federal level, while state-level institutions supported those at the federal level and public corporations. With regard to industrial policy, apart from MITI the key agency responsible for promoting investment (FDI as well as domestic investment) is the Malaysian Industrial Development Authority (MIDA). MIDA focuses on promoting investment in the manufacturing sector but lately it is also responsible for promoting investment in services.

Specialized institutions and corporations have been set up to focus on identified sectors and are responsible for sector-level policies. Heavy industries were provided support with the establishment of the Heavy Industries Corporation of Malaysia (HICOM), a wholly government-owned corporation, in November 1980 (it was renamed HICOM Berhad in December 1993). In 1983, with the establishment of Proton, the national car project was launched, with Mitsubishi as the foreign partner. HICOM held 70 percent of the equity and Mitsubishi Motors Corporation and Mitsubishi each held 15 percent of the total equity. The first national car, a Proton Saga, was produced in 1985. In November 1995, the DRB-HICOM Group was established as an integrated automotive company. In 1994, DRB formed a joint venture with Proton to develop, manufacture, and sell Proton cars. A second national car corporation, Perusahaan Otomobil Kedua Sendirian Berhad, (Perodua), a joint venture between some Malaysian companies and Daihatsu, Japan, was established in 1992. In 1994, Perodua launched the Kancil, a compact economical car. In 1992, Inokom Corporation Bhd., a joint venture with Hyundai (Republic of Korea) and Renault (SA), was formed to manufacture light commercial vehicles. A fourth national car company, NAZA, was formed in 1996, also a joint venture with a Korean

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[28] Despite the lucrative offers, in early 1992 during the energy company Tenaga Nasional Berhad's privatization, industrial action was organized by middle management executives to demand better bonuses and to restrict the power of the Board of Directors over senior and middle executives.

company, Kia. Motosikal dan Enjin Nasional Sendirian Berhad (Modenas), a joint venture with Kawasaki Heavy Industries, produced Kriss, a 4-stroke, 110 cc motorcycle. Similarly, for support to the shipbuilding industry, the government set up the Malaysia Shipyard and Engineering Sendirian Berhad (MSE) in 1973, later renamed the Malaysia Marine and Heavy Engineering Sendirian Berhad (MMHE) to undertake repairs, shipbuilding, and offshore and onshore engineering. It was privatized in 1991.

Policy Implementation Machinery Design

What factors were influential in the design of the implementation machinery or regime? Implementation matters a great deal in the successful execution of economic policies. Even sound policies will be ineffective if they are implemented badly. Policies have to be turned into actions to deliver results that are tangible. The successful implementation of policies requires effective institutions; leadership; and clarity of purpose, processes, and mechanisms. There is also a large measure of learning by doing.[29] Policies must be coordinated and be consistent. A good delivery system, therefore, is very essential for the implementation of economic policies. Too rapid a turnover of technocrats erodes continuity and institutional memory and weakens implementation capacity. These are general principles, but useful in evaluating the Malaysian experience.

The involvement of the executive arm of government—the Cabinet and Prime Minister's Office—in the implementation of policies is determined by the importance of the policies. Generally, implementation of policies is left to the lead agencies, for example the various ministries and departments, and the Cabinet or Prime Minister are involved only if policy issues cannot be agreed to or resolved by the agencies. Coordination among agencies is vital, and the lead is taken by the key agency responsible for the policy. Cabinet committees, with the Prime Minister or Deputy Prime Minister as chairman, are established to oversee implementation when it is thought that the policy is of some importance, and it is anticipated that there will be serious problems over coordination. But there is always the threat of burdening the Cabinet with too many committees.

Prime Minister Mahathir took special interest in privatization, heavy industries, and the MSC, and was closely involved with the implementation of these policies and programs. The personal involvement of the Prime Minister ensured that the policies were implemented. Strong leadership by Rafidah Aziz, the MITI, was also instrumental in implementing trade and industrial policies. MIDA, which reports to the MITI, has played a key role in the implementation of

[29] Privatization in Malaysia is an example of a policy that evolved through implementation and through a process of learning by doing. It began with broad statements on the rationale, objectives, and methods, but the policy evolved through the implementation of specific privatization projects, and progressively it was made clearer and more effective with experience in implementation. Privatization policy was motivated by the belief in the efficacy of a market system with active private entrepreneurship, and the belief that the government had no business to be in business.

the various industrial policies and in the implementation of the past two industrial master plans and the current third industrial master plan. The involvement of private sector entities in policy implementation is vital as they provide important feedback on the unexpected problems that are encountered when the policies are implemented and need to be refined. Private sector feedback is useful, especially when incentive measures are to be implemented. The MITI and MIDA usually take the lead when the private sector is involved in implementation issues.

The MOF plays an active part in the implementation of fiscal incentives for manufacturing industries. Although the initiation of the broad fiscal incentives such as pioneer tax holidays, investment tax allowances, and export incentives could come from the EPU, MITI, or MIDA, the details of implementation of fiscal incentives requires the expertise and assistance of the MOF. Implementation of the MSC was supported by liberal fiscal incentives for the MSC companies.

A system of oversight on implementation has been developed and maintained but the quality varies among groups and agencies. Oversight on policy implementation takes place at different levels of government. Legislative oversight follows the parliamentary system, with Parliament holding three sessions during the year. Progress on the implementation of economic policies usually are debated when budgets are submitted to Parliament, questions are raised by the opposition and other members of Parliament, requests are made for information on the state of implementation, and also on specific programs and projects that come under each economic policy.[30] The recent debate in Parliament over the APs and the NAP is an example of the extent of involvement of the legislature in monitoring policy changes. Debates over policies, programs, and projects also engage the legislature when the five-year plans are submitted to Parliament for approval. Both the budget and the development plans need the approval of Parliament for financial allocations to take place.

The implementation oversight system is usually integrated within a planning horizon and framework. There is a tendency to formulate master plans covering the medium to the long-term and the industrial and other economic policies are evaluated within the planning framework. There is an Implementation and Coordination Unit (ICU) in the Prime Minister's Department that is responsible for monitoring the implementation of the programs of the plans.

Within the bureaucracy, the system of oversight usually involves setting up steering committees, councils, or groups. Steering committees, which are led by and composed of senior technocrats, are responsible for specific areas of policy to ensure that implementation progresses on track and to resolve implementation problems. For the Second Industrial Master Plan 1996–2005, for example, the institutional framework comprised an Industrial Coordination Council (ICC),

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[30] The opposition has, on occasion, pressed for the setting up of Royal Commissions to look into specific policy areas and on the implementation of developmental projects.

and Industrial Policy and Incentive Committee (IPIC), Private Cluster Working Groups (CWG), and Strategic Thrust and Initiative Task Forces (STITF). The MITI served as the Secretariat to the ICC and the other groups. Problems over the implementation of industrial policies are also dealt with at the MITI Annual Dialogues with the private sector, but the resolution of implementation problems is a continuing process and is not contingent on the dialogues.

Over the last few years there has been a great deal of emphasis on implementation and improving the delivery system of the government. A National Implementation Task Force (NITF) with the Prime Minister as Chairman was established in 2006 to oversee the implementation of the Ninth Malaysia Plan.[31] The private sector, through PEMUDAH, a joint public-private sector committee, is also involved in assessing the government implementation machinery and making recommendations on improving the delivery system. While hardly new, increasingly the focus of attention is moving towards the implementation of policies at the level of state governments and local authorities.

State governments are involved in the implementation of federal economic policies, especially through their responsibility to approve requests for land and licenses. Under the constitution, land is under state-level jurisdiction, and all requests for land, such as for industrial estates, must be approved by the state governments. Licenses are actually approved by the local authorities that come under the state governments. There has been a lot of criticism of the slow process in granting approvals for land acquisition and licenses by the state governments. One of the approaches taken to circumvent the constraints on growth and development within a federal system of government is to create a federal territory by purchasing land from the state government. Land for the development of Putrajaya, Cyberjaya, and the MSC were acquired, with financial compensation from the Selangor state government, and this probably assisted in speeding up development of these clusters.

Technical and Financial Underpinnings

Industrial policy has been sensitive to the financial implications of the programs and projects designed to provide content to policy, as well as to their technical feasibility. The financial feasibility of the heavy industries projects, for example, has always been a matter of concern. As another example of the formal recognition of feasibility and sustainability, protection accorded to the national car and iron and steel projects attracted attention from the start. Malaysia even requested a delay in opening up the automotive sector to ASEAN member countries. Detailed pre-feasibility studies preceded most megaprojects—in 1981 for setting up an engineering complex, for example. Fiscal incentives have always been used prolifically for manufacturing projects and these include the

[31] Members of the NITF include the Deputy Prime Minister, Minister in the Prime Minister's Department, Minister of Finance II, Minister of Entrepreneur Development, senior technocrats and advisers..

granting of pioneer status to FDI, which exempts investors from corporate tax. Investment tax allowances and export incentives have also been part of the fiscal incentives. In granting these incentives, the MOF provides estimates of the revenue that is forgone. An influential view on fiscal incentives and corporate tax is that when the full impact of investment incentives are taken into account, Malaysia's overall tax level on investors is not that much higher than other countries in the region.[32]

The financial underpinnings of privatization were a major plank of that policy. A key objective of the privatization was to reduce the financial burden of the government. The sale of enterprises to the private sector was seen as one method of earning revenue as well as reducing the financial burden of operational and other expenses on the government from underperforming entities. Increasingly, reducing the fiscal deficit of the federal government has become a major concern of the policy makers and the long-term objective is to strive for a balanced, or near-balanced, budget. As mentioned earlier, even the financial allocations for programs and projects for the distributional restructuring of society had to be trimmed down when growth slowed and financial tightness emerged.

6. Role of Leadership and Implementing Machinery in Achieving Outcomes

Leadership, the capacity to make decisions, has played a crucial role in the growth and development of the Malaysian economy. The pre-1970 growth and development phase was marked by the concern with diversifying the economy away from reliance on (declining) commodity prices, shifting resources from low-productivity to high-productivity agriculture, and the beginnings of the push towards industrialization. The leadership grappled with these developmental challenges. Leadership in the post-1970 period was faced with the challenge of distributive demands and wide ethnic economic imbalances arising from the May 1969 racial riots, and the need to raise the pace and intensity of industrialization. A stylized view would suggest that agricultural diversification and rural and infrastructure development were the outstanding features of the pre-1970 phase, while the post-1970 phase was marked by the need to promote rapid industrial growth, with concerns for equity and the structural transformation of the economy.

The two phases of growth demanded different types of leadership and it was not just a matter of making decisions but making the "right" decisions and seeing them through to implementation. It was also not simply a matter of focusing on the big picture, or big decisions, but also for overseeing the details,

[32] World Bank (2006).

and ensuring that there would be no unproductive deviations from the main policy thrusts. The two prime ministers who led the *Barisan Nasional* government in 1970s, before Mahathir Mohamed took over the leadership, were Tun Abdul Razak and Tun Hussein Onn. Abdul Razak launched and steered the NEP, Hussein Onn continued with sustaining the government's strategies and policies, and Mahathir built on past achievements while steering development in new directions.

Comparisons between Abdul Razak and Mahathir help bring out some of the broad attributes of leadership in Malaysia. Abdul Razak, trained as a lawyer and with long experience with the civil service, was more of an implementer, focusing on rural and agricultural development. He was also instrumental in providing leadership during the crisis of May 13, 1969, and later, and oversaw the emergency that was declared following the crisis. With his technocratic background, he worked effectively with the civil service, and his adoption of the Red Book system was a major contribution to the oversight and monitoring of developmental programs and projects. Abdul Razak steered the transformation of rural and agricultural development through the massive land development schemes undertaken by FELDA and initiated and saw through the formulation and launch of the landmark NEP in 1971 and its implementation in the early 1970s, before his death in 1973.

A shift in the type of leadership took place in the early 1980s. Mahathir became Prime Minister in 1981, when Hussein Onn resigned as Prime Minister after a slow recovery from complicated heart surgery. Relinquishing his Minister of Trade and Industry portfolio, he began his long 22-year stewardship of the country. Mahathir, trained as a medical doctor, introduced a different style and content to leadership, which was often perceived as abrasive, confrontational, and heterodox. The relatively tactful approach of previous leaders was replaced by leadership from the front, setting the tone of "leadership by example." In the initial years of his leadership, Mahathir repeatedly emphasized the importance of values and ethics that were needed for rapid and sustainable development.

Although these values for growth and development were directed to the *Bumiputera* and the promotion of discipline and the work ethic was linked to Islamic moral values, they had wider appeal to all Malaysians.[33] Mahathir continually emphasized that hard work was an important individual and societal value, and that this positive work ethic was necessary for rapid economic

[33] For Mahathir's views on the problems of Malay development, see Mohamed (1970) and Mohamed (1986). See Mauzy and Milne (1986) for the association between discipline and Islam. Mahathir was more involved in day-to-day administration and supervision of civil servants. He introduced the "clock-in" requirement for all civil servants, the use of nametags, and the declaration of assets by ministers and others. He cited several Japanese qualities as essential factors in economic development: hard work, discipline, loyalty, unselfishness, efficiency, cleanliness, orderliness, sincerity, thrift, and trustworthiness. Apart from Singapore's Lee Kuan Yew, among the democratic leaders of Asia Mahathir was arguably one of the staunchest believers in social engineering at the level of individuals and households.

growth. However, unlike neighboring Singapore, which permitted strong material incentives to extract higher effort from public officials, Mahathir's Malaysia expected high returns from moral suasion. Mahathir was also critical of the West and the legacy of colonial rule. So he revived the rhetoric of economic imperialism and urged Malaysians to turn to the east in his Look East Policy, emulating not only the work ethics of successful East Asian countries but also their approach to growth and development. Japan and Korea were singled out as models and over the years a large number of Malaysians were sent to those countries for training and to pursue their tertiary-level education. East Asia ranked highest in terms of foreign policy priorities, followed by ASEAN, Islamic nations, nonaligned nations, and a clear shift away from the United Kingdom.[34]

Mahathir's leadership was also marked by the pursuit of a more visionary approach, specifically of Vision 2020, which is intended to serve as a compass to guide Malaysia to developed-country status by 2020. Vision 2020 is benchmarked against the OECD countries with the level of per capita income being the key performance indicator. It anticipates that the economy would have to grow at a rate of about 7 percent per year to reach the target level of per capita income. Subsequent assessment suggests that a slightly lower growth rate of 6.3 percent per year over 2006–20 would suffice to reach the average OECD level of per capita income.[35]

7. Management of Growth and Distribution Issues

Equity, or distribution, was a major preoccupation of the post-1969 period, and the effects of the racial riots of that year were seminal for development strategy and policy making. The NEP, launched after the riots, was a complex socioeconomic policy. One prong of the policy emphasized eradicating poverty irrespective of race. The other focused on affirmative action for employment and asset-creation programs for the restructuring of society to correct the identification of race with economic function. There has been a lot of progress in reducing poverty, but income imbalances remain sizable (tables 10, 11, and 12). Although it had other ramifications, much attention and thought went into the effects a proactive distribution policy would have on economic growth.

[34] Mahathir was upset when the United Kingdom raised student fees in late 1981, affecting about 13,000 Malaysian students in the United Kingdom, and retaliated by stating that the Malaysian government would give preferences to buying goods from countries other than the United Kingdom.

[35] Work undertaken for the IMP3 in 2005-2006 indicated that a growth rate lower than the original 7 percent per year would be adequate to reach the level of the OECD per capita income. Currently, it is estimated that Malaysia's PPP-adjusted per capita in 2005 reached US$10,318, which was above Mexico's (US$9,991) and below Poland's (US$13,364).

Table 10: Incidence of Poverty and Hardcore Poverty, 1999 and 2004

		1999			2004		
		Malaysia	**Urban**	**Rural**	**Malaysia**	**Urban**	**Rural**
Hardcore poverty							
Incidence of hardcore poverty[a]	(%)	*1.9*	*0.5*	*3.6*	*1.2*	*0.4*	*2.9*
Number of hardcore poor households	('000)	91.7	11.9	79.8	67.3	14.1	53.2
Poverty gap[b]	(%)	*0.4*	*0.1*	*0.8*	*0.2*	*0.1*	*0.6*
Overall poverty							
Incidence of poverty[c]	(%)	*8.5*	*3.3*	*14.8*	*5.7*	*2.5*	*11.9*
Number of poor households	('000)	409.3	86.1	323.2	311.3	91.6	219.7
Poverty gap	(%)	*2.3*	*0.8*	*4.0*	*1.4*	*0.6*	*3.0*
Total households	**('000)**	**4,800.0**	**2,612.5**	**2,187.5**	**5,459.4**	**3,605.9**	**1,853.5**

Source: Economic Planning Unit (2006).

Notes:
a. Refers to households with monthly gross income of less than the food PLI.
b. Refers to the total income shortfall (expressed in proportion to the poverty line) of poor households.
c. Refers to households with monthly gross income below PLI.

Table 11: Incidence of Poverty and Hardcore Poverty by Ethnic Group, 1999 and 2004 (%)

	1999			2004		
	Bumiputera	**Chinese**	**Indians**	**Bumiputera**	**Chinese**	**Indians**
Hardcore poverty	*2.9*	*0.2*	*0.3*	*1.9*	*0.1*	*0.3*
Urban	*0.7*	*0.1*	*0.2*	*0.7*	*neg.*[a]	*0.2*
Rural	*4.4*	*0.4*	*0.5*	*3.3*	*0.3*	*0.5*
Overall poverty	*12.4*	*1.2*	*3.5*	*8.3*	*0.6*	*2.9*
Urban	*5.1*	*0.8*	*2.4*	*4.1*	*0.4*	*2.4*
Rural	*17.5*	*2.7*	*5.8*	*13.4*	*2.3*	*5.4*
Poverty gap	*3.3*	*0.2*	*0.7*	*2.1*	*0.1*	*0.6*

Source: Economic Planning Unit (2006).

a. Less than 0.05 percent.

Table 12: Mean Monthly Gross Household Income and Gini Coefficient by Ethnic Group and Strata, 1999 and 2004

Ethnic group and strata	In current prices (RM)		Average annual growth rate (%)	In constant 1999 prices (RM)		Average annual growth rate (%)	Gini coefficient	
	1999	**2004**	***2000–04***	**1999**	**2004**	***2000–04***	**1999**	**2004**
Bumiputera	1,984	2,711	*6.4*	1,984	2,522	*4.9*	0.433	0.452
Chinese	3,456	4,437	*5.1*	3,456	4,127	*3.6*	0.434	0.446
Indians	2,702	3,456	*5.0*	2,702	3,215	*3.5*	0.413	0.425
Others	1,371	2,312	*11.0*	1,371	2,150	*9.4*	0.393	0.462
Malaysia	**2,472**	**3,249**	***5.6***	**2,472**	**3,022**	***4.1***	**0.452**	**0.462**
Urban	3,103	3,956	*5.0*	3,103	3,680	*3.5*	0.432	0.444
Rural	1,718	1,875	*1.8*	1,718	1,744	*0.3*	0.421	0.397

Source: Economic Planning Unit (2006).

Growth and distribution issues occupied center stage during the leadership of Mahathir, with shifts in emphasis over the years. The Malaysian growth story over the last 35 years can be viewed as a constant tussle between concerns with distribution, especially its ethnic dimensions, and concerns with the growth of the economy.

Even at the beginning, when the NEP was launched in 1971, the perceived tradeoff between growth and distribution occupied the minds of the policy makers. Many sections of the leadership believed that too much emphasis on equity would undermine the economic growth. For the private sector, particularly the Chinese private sector, the NEP was seen as discouraging private investment, and many felt it would dampen growth; this remained a continuing complaint of the private sector during the 1970s and 1980s. Yet, there was also a substantial body of opinion on the other side, that a laissez-faire approach to development or a trickle-down path would only worsen distribution and accentuate the existing sharp economic imbalances between the Malays and non-Malays. In the end, the growth of the economy, despite the focus on distribution over the last 30 years, has been quite creditable.

The stated strategic approach to attaining the goals/targets of the NEP was one of distribution through growth.[36] Implementing the approach was not as straightforward. The original version of the statement was tied closely to the second prong of the NEP—that is, restructuring society to correct the identification of race with economic function—and it focused more narrowly on the restructuring of the ownership of share capital. The two key implementation issues had to do with the notion of growth and whether the strategy was to be implemented only at the macro or at the micro level too.

A narrow definition of growth would mean that the distribution/restructuring of share capital could only be implemented when the share capital of a company had grown. It was recognized, of course, that a company could grow through recourse to loan capital rather than share capital and that sales, exports, and employment could also be used as indicators of corporate growth. It was a contentious implementation issue. The implementation of the strategy meant that large companies in the economy had to comply with the condition that at least 30 percent of their share capital was allocated to *Bumiputera*.

Implementation of the distributive strategy led to the adoption of a variety of measures, mainly quotas, sometimes covering just the ownership of share capital and at other times more than share capital, at levels that were above the

[36] The *Mid-Term Review of the Second Malaysian Plan, 1971–1975*, which was published in 1973, restated the NEP. It said, "The efforts to attain these objectives will, in turn, be undertaken in the context of rapid structural change and expansion of the economy so as to ensure that no particular group experiences any loss or feels any sense of deprivation in the process" (EPU, 1974, p. 1). This statement was made repeatedly, to contrast with the approaches of nationalization, "disruptive distribution," or the populist statement of "robbing Peter to pay Paul."

threshold for companies that are under the Industrial Coordination Act (ACT). Companies incorporating for business usually had to have at least 30 percent of their share capital allocated to *Bumiputera*, including those that were seeking public listing on the stock exchange. Corporate transactions through mergers and acquisitions, when they fall under the Guidelines of the Foreign Investment Committee (FIC) on Takeovers and Mergers, had to restructure their ownership structure to comply with the NEP. Usually, however, some leeway was granted on the timeline for compliance. Companies were required to submit their growth and restructuring plans if they were unable to restructure their companies in the short term.

Restructuring the employment pattern to reflect the ethnic composition of the population was implemented more flexibly. Even more than financial capital, or share capital, it was recognized that time would be needed to increase the supply of skilled *Bumiputera,* and there was awareness that if less-skilled *Bumiputera* were employed to meet the quotas, the growth of the enterprise would be affected adversely. Flexibility in implementing the distributive employment policy was practiced for over much of period covered by the NEP, and enterprises were generally given ample time to restructure their employment patterns.

The growth of public enterprises and other governmental institutions supplemented the other distributional approaches. Two broad approaches were utilized. *First*, public enterprises expanded in new growth areas, especially through the Urban Development Authority and the State Economic Development Corporations (SEDCs). These new growth areas provided opportunities for *Bumiputera* businesses and entrepreneurs. *Second*, institutional investors such as PNB provided the channel for individual *Bumiputera* to invest in unit trusts. These initiatives—public investment in new regional growth centers—produced mixed results but, overall, they were disappointing.

Public investment in specific areas for urban renewal, and in new areas owned by the state to provide growth opportunities in commerce and industry, were predicated on the belief that it would be difficult and disruptive to restructure existing urban assets owned by non-*Bumiputera*. At the same time the takeovers of British-owned mining and plantation companies in the 1970s and 1980s, but not the Chinese plantation and mining companies, exemplified efforts in avoiding encroachments on the existing wealth of the Chinese.

Although the economy grew at 7 percent per year over the 1971–85 period, there was a slowdown in the 1981–85 period. The close attention given to growth and distribution was well illustrated when growth slowed. The NEP was held in "abeyance" as the focus was on getting the economy to grow. Poor growth and economic slowdown can contribute to instability. The 1987 political contests and fragmentation of UMNO, between supporters of Mahathir and his opponents, came at the tail end of the slow growth phase in the economy. This is a recurring pattern, seen in most democratic systems but especially in East Asian systems

marked by growth fundamentalism, where for a leader, delivering the economic goods is often the strongest claim to legitimacy.

The distribution policy issues that needed management were at two levels. *First* are the macro links between growth and distribution. The key policy issues and questions posed were as follows: What is the nature of distribution in relation to economic growth? Are there phases in growth and distribution? Do the poor get poorer? What effect will a strong focus on distribution have on economic growth? How is restructuring through growth to be implemented? Should distribution be emphasized only at the macro level, or should there be implementation at the level of individual corporations and economic entities?[37] *Second*, there were implementation issues at the sectoral and individual level even after consensus had been reached at the macro level. Poverty and poverty policies posed far fewer problems than issues of income distribution, especially in relation to the restructuring of society with the explicit target of 30 percent *Bumiputera* ownership of share capital by 1990 and the extension of the timeline beyond 1990. Opposition to the NEP and to the emphasis on distribution was based on the off-cited premise that it would severely and adversely affect private investment, lead to preferential treatment lavished on unqualified *Bumiputera,* and, therefore, would undermine economic growth. Recent events leading up to the March 2008 elections, and the immediate post-election repositioning on national policies by the various parties, suggest that a wider circle than technocrats and other decision makers have shared some of these concerns.

The official view on income distribution was to accept the likelihood that income inequality could widen, but that wide and widening income inequality would be bearable if it was associated with a decline in absolute poverty. With high growth rates, absolute poverty did indeed fall from about half of the population in 1970 to about 7 percent in 2004, even though there were episodes of widening and narrowing inequality in incomes over the 1970–2005 period. While the Gini coefficient fell during 1970–2004, it rose in the late 1990s: the Gini coefficient stood at 0.425 in 1999, rising to 0.462 by 2004, while the incidence of poverty continued its downward trend. Income disparity between the *Bumiputera* and non-*Bumiputera* was still sizable (tables 10, 11, and 12).

Beginning in the mid-1980s, the leadership gradually downplayed concerns with income inequality, and the issue seemed to have been marginalized. The preoccupation with growth gained greater prominence over inequality and inter-ethnic economic imbalances under Mahathir's leadership. Economic conditions played a role in the relative (to the past) "neglect" of income distribution and the restructuring of society, especially with regard to *Bumiputera* ownership in the corporate sector. *First*, Mahathir Mohamed appeared to have accepted the likelihood that income inequality could widen with economic growth. *Second*, when he took over the leadership of *Barisan Nasional*, economic growth had

[37] Much of the discussion was shaped by the Kuznets hypothesis on growth and inequality.

slowed down. Reviving economic growth was of high priority, and the government relaxed FDI policies.[38] *Third*, with the privatization policy and the emphasis on private-sector led growth and the downsizing of the public sector, there was less pressure from the state channeling resources to the *Bumiputera*. *Fourth*, the 1980s witnessed a pick up in the liberalization of the economy and external pressures and commitments to the WTO meant that the degrees of freedom for the government to pursue its affirmative action policies began to be circumscribed. These trends continued and persisted into the 1990s. *Fifth*, the Asian financial crisis had serious effects on the economy; the economy contracted by 7.4 percent in 1998. With the breakout of SARS and the impact of the post-September 11th environment, the economy grew only by 3 percent per year during 2001-2003.

The key and persistent distribution issue concerns the need for continuing with the push to restructure society and, specifically, to achieve the 30 percent ownership target for *Bumiputera*. Ownership has been languishing at about 19 percent, with a sizable proportion held by institutional investors.[39] Slower economic growth affected the growth of investment, and therefore there was slower growth in share capital, the entry point for *Bumiputera* ownership. Ownership also fell because many *Bumiputera* shareholders had divested over the years.[40] There were recurrent distribution issues, which included concerns regarding the restructuring of individual companies, the threshold for the exemptions from restructuring, the timeline granted for restructuring, and whether companies that had complied with ownership restructuring had to restructure again if *Bumiputera* ownership fell below 30 percent of total share capital.

The leadership was also concerned about the effect of the affirmative action policies on economic growth. It oscillated between rigid implementation and more liberal and flexible approach, often using fiscal incentives to support affirmative action. Subsequently, the deadline for reaching the 30 percent ownership target was extended to 2020. In addition, the government granted enterprises some flexibility to restructure their patterns of employment and ownership, in addition to the extensions on the time to meet the NEP targets. Despite this, the general concern about the constraints imposed by the NEP on the growth and operations of the private sector persisted throughout the post-1970 period. The NEP was often blamed for the poor performance of private investment. By the mid-1990s, the pressures from globalization and greater integration, competition from emerging economies, and the momentum for

[38] Foreign investors were allowed to hold majority ownership in export-oriented industries.

[39] The arguments from the think tank ASLI in late 2006 that *Bumiputera* ownership had exceeded the 30 percent target provoked a rebuttal from the government, which asserted that the ASLI estimates were flawed.

[40] The government has reported that about 80 percent of the contracts that had been awarded to *Bumiputera* had "leaked," that is, eventually ended up with non-*Bumiputera* businesses.

greater liberalization of the economy imposed constraints on pushing ahead with affirmative action policies.

Liberalization of the economy and the need to promote new areas of growth have led to a more muted approach to affirmative action. The case of the automotive industry provides an example. A large number of *Bumiputera* vendors provide various parts of the national car, but the quality of the vendors has been variable. Opening up the automotive sector, reflecting the commitments under the ASEAN Free Trade Area (AFTA), would raise the level of competition from imports of cars into the Malaysian market. Malaysia requested a delay in liberalization from 2005 to 2006, as it introduced measures to rationalize the automotive sector. Currently, Proton Holdings Behad is negotiating with foreign interests to assess their interest in forming a joint venture with Proton Holdings Berhad, but the interests of the *Bumiputera* vendors also need attention. Proton has seen its market share drop from almost two thirds (65 percent of the passenger car sales) to less than 40 percent. At the same time, the controversy over the APs and the formulation of the NAP had to take into account the position of the national car and the *Bumiputera* holders of APs. As part of the NAP, the APs will be phased out by 2010.

The MSC and new growth regions, on the other hand, adopted from the start a more liberal stance with regard to FDI. The foreign companies that were established in the MSC were granted wholly owned status, without the need to allocate any share capital to *Bumiputera* interests, and also enjoyed fiscal incentives. More recently, a similar liberal stance was adopted for the Iskandar Development Region (IDR) in Johore, adjacent to Singapore, which exempted investors from the 30 percent target and provided liberal fiscal incentives for investing in selected services industries—creative industry, education, financial advisory and consulting, health care, logistics, and tourism. Investors in these sectors will be granted exemption from corporate income tax for activities within the zone and outside Malaysia for 10 years, on the condition that they commence operations before 2015. Investors can source capital globally and employ foreigners without restrictions. These liberalization measures have been controversial. Mahathir (after his tenure as Prime Minister ended) has criticized the measures proposed for the IDR, as he believes that the Malays still cannot compete on an equal footing with other Malaysian groups or with non-Malaysians, and that Malaysians would lose their land and sovereignty in the IDR.[41] The export-oriented manufacturing industries, which include electrical and electronic products, were also treated liberally with regard to the ownership policy.

In sum, different dimensions of distribution have been of concern. The leadership seems less concerned with overall income inequality than with inequality between the ethnic groups. Inequality within the *Bumiputera* is now an

[41] Mahathir was quoted as saying, "We became slaves in our country because we gave it to others" and "Malays will be enslaved again by foreigners." See *Straits Times*, March 30, 2007.

added concern for the UMNO, which represents Malay interests. Whereas in the past a watchful eye was kept on intra-*Bumiputera* economic imbalances, there was a willingness to accept the fact that inequality within the *Bumiputera* group was higher than within the Chinese and Indian communities. There were, of course, underlying political considerations. Catching up with the income levels of non-*Bumiputera* would have greater political payoff than in ensuring better intra-*Bumiputera* inequality. Within the *Bumiputera* community, despite the fall in absolute poverty, especially from the mid-1990s, the political repercussions from giving intra-group equality a lower policy weight became apparent. Dissatisfaction grew over the allocations of government contracts, government-funded projects, and the perceived beneficiaries of privatized projects and licenses. Often, it was alleged that political connections to the leaders mattered more than project viability and capabilities of the contract recipients in getting access to government largesse. This, together with the rapid and visible rise of a few selected *Bumiputera* businessmen under Mahathir's leadership, has led to increasing discontent within the *Bumiputera* community. To compound matters, the widening of intra-*Bumiputera* inequality coincided with the late-1990 to post-2000 increase in overall income inequality. By the mid-2000s the so-called "Malay Agenda," a code-word for a return to worries over the economic position of the Malays and inequality within the *Bumiputera*, surfaced and was debated vigorously.

8. Policy Adaptation, Learning, and Adjustment

Adapting strategies and policies to changing conditions is a prerequisite for sustaining growth. Speedy adaptation is even better for growth. A speedy response is a hallmark of decisive leadership and appropriate mechanisms for analysis and implementation, and enhances reputation while improving outcomes. There are several examples—cited earlier—of midcourse adjustments to unexpected changes in the economic environment or corrections for underachievement on growth targets. In recent years, the demand for efficient and speedier decision making by the government has been mounting, promoted under the rubric of the government's "delivery system."

From what sources does adaptation originate? As mentioned earlier, external pressures for change have been rising, and the Malaysian leadership is acutely aware of extra-territorial developments. The international ranking of the economy in terms of various measures of competitiveness is monitored continuously, evaluated, and deliberated at the highest level. One sign of the seriousness of this effort is the creation of the Cabinet Committee on Competitiveness. However, political and social conditions must also be conducive for implementing change without unproductive opposition. A discontinuity in institutions or leadership is often associated with purposeful

policy adaptation. For example, as mentioned earlier, many policy changes introduced in the post-1980 period were associated with the change in political leadership. Mahathir's 22-year leadership started in 1981, and this change altered the course of Malaysian development.

Implementation of the policies is also reassessed continuously in the context of broader economic performance and specific targets. A few examples illustrate how the process has worked in Malaysia. Following the sharp rise in world oil prices in 1979, the world economy experienced a sharp downturn in 1980. Malaysian GDP grew at 7.1 percent in 1981, slowed to 5.6 percent in 1982 and 5.8 percent in 1983, and the three-year growth rate averaged well below the Fourth Malaysia Plan (1981–85) target of 7.6 percent (EPU, 1984). Manufacturing and construction also grew well below the plan's target, with manufacturing contracting in 1985, while private investment decelerated to 0.3 percent in 1982. Growth expectations for 1984–85 were also downbeat. The adjustments made to macroeconomic policies moved in the direction of consolidating the public sector, seen in a decline in current and capital public sector expenditures. The burden of growth fell on private investment, and the policy of privatization and the Look East Policy were launched in these difficult period. Further adjustments were made to the Industrial Coordination Act of 1975, which was seen as constraining private investment. The government also listed the new directions in development and implementation strategies in the Mid-Term Review of the Fourth Malaysia Plan, 1981–85.

Growth slackened in the mid-1980s with the collapse in commodity prices and stagnating exports. Slower private investment and the deflationary effects arising from the consolidation of public sector to contain the budgetary deficit lowered overall GDP growth for the first time since 1957. Output contracted by 1 percent in 1985, and grew by 1.2 percent in 1986, all below the growth target of the Fifth Malaysia Plan, 1986–90 (5 percent per year). Private investment contracted in 1985 (−8.6 percent) and 1986 (−16.3 percent). Liberalization measures continued, including reductions in administrative controls, simplified bureaucratic procedures, the relaxation of the guidelines for the acquisition of assets for foreign investors, and a reduction in the corporate tax rate. Public sector policy adjustments took the form of a reduction in investment (30.9 percent) of the NFPEs while public consumption growth was contained. Cutbacks were made for financial allocations to support the NEP restructuring programs; the plan's allocation of RM 4.2 billion was reduced to RM 2.7 billion.

The response to the Asian financial crisis in 1997/98 provides another example of the nimble policy adjustment process in operation in Malaysia. Malaysia's response was unorthodox; ignoring the standard advice of the IMF, capital controls were imposed and the currency was pegged at RM 3.80 to the U.S. dollar in September 1998. The ringgit was de-internationalized.[42] At the

[42] For an account of the background and response to the financial crisis see Athukorala (2001), Abidin (2002), and Tourres (2003).

same time, the government instituted a National Economic Action Council (NEAC) and launched a National Economic Recovery Plan (NERP) to cope with the financial crisis. Additional liberalization measures were also introduced. In 2006 the ringgit was unpegged from the U.S. dollar.

Similarly, the Eighth Malaysia Plan (2001–05) was launched in 2001 and had set a growth target of 7.5 percent per year. However, the uncertainties generated by international terrorism in the post–September 11 phase, wars in Afghanistan and Iraq, and the outbreak of Severe Acute Respiratory Syndrome (SARS) dampened GDP growth to 3 percent per year, and private investment declined by 11.1 percent during the 2001–03 period. The government responded quickly. Incentives, including the revision of guidelines for private investment were introduced in the 2002 and 2003 budgets, and in May 2003 the Package of New Strategies to stimulate growth was launched.

More recently, additional liberalization measures were introduced to stimulate private investment and growth. The latest changes to economic policies were the loosening of conditions for FDI in the Iskandar Development Region in Johor. New measures have also been introduced to speed up decision making within the core and line ministries and to strengthen the delivery system.

9. Lessons from the Malaysian Experience

The Malaysian growth experience over more than 30 years provides a useful case study that touches on the key themes that are of interest to the Growth Commission. Some of the key lessons that can be drawn up are as follows.

First, the Malaysian experience is an example of how an economy relatively rich in natural resources can escape the so-called "resource curse" and transform itself into a more industrialized economy over a period of about 20 years. The process of structural transformation through diversification, with rising competition in the global export markets for manufactured products, needs to be continuous. Resource-based manufacturing industries, such as rubber and palm oil products, can contribute to the growth of manufacturing, but specialization is needed. The basic transformation was in the direction of moving up into more niched products in complex value-added chains, and this is true for the manufacturing sector as well. The same process of moving up the value-added chain is required for electrical and electronic products as the economy loses its comparative advantage in the manufacture and exports of labor-intensive products that eventually acquire the characteristic of commodities.

Second, the promotion of heavy industries, including automotives, underscores the difficulties and costs of attempting to move into areas where an economy has no strong comparative advantage. Continuing protection to the heavy industries has been made more difficult by the pressures from forces of competition and liberalization.

Third, privatization represents just one method of expanding private enterprise in an economy. Various implementation problems have surfaced in Malaysia, which together suggest that strong regulatory oversight is required as well as contingencies to reabsorb within the public sector a certain proportion of previously privatized projects that have not succeeded. Moreover, although privatization is a powerful instrument for giving the private sector a head start despite limited entrepreneurial skills, it is questionable as a sustainable strategy. This is true, especially, for heavy industry, with its lumpy capital requirements and the need for a critical mass of complex management and technical skills that may not be available readily. New and aggressive firm formation seems, by far, to be a more viable strategy for the long haul. The Malaysian experience suggests also that the "business incubator" model, adopted by many countries to promote small enterprises, may have its own problems. Getting the balance right between the "nature" and need for animal spirits among entrepreneurs and the "nurture" provided by government is difficult, especially in situations where the targeted beneficiaries constitute a powerful voting block.

Fourth, new sources of growth need to be found, coupled to new firm formation. Almost uniformly across East Asia, services are a new growth sector. The MSC in Malaysia is an example of government attempts to ramp up the promotion of services in ITC. Promoting services in the MSC requires a strong infrastructure, as well as incentives for FDI and a reliable supply of skilled human capital.

Fifth, an appropriate regime of policy making and implementation—aligned with developmental objectives, technical capacities, and political and social imperatives—needs to be in place to sustain economic growth. There is a need to continuously respond to outcomes and results, and to initiate adjustments to policies. Experimentation is also vital: the privatization policy and the MSC are two examples of experimentation in the Malaysian setting. There has been a process of learning too: when the affirmative action NEP was introduced and subsequently implemented, it was a fresh, new, and uncertain area, especially as its impact on economic growth and learning lay in the actual implementation of the policy.

Sixth, managing growth and distribution issues is a continuous process and adjustments are required as policies are implemented. The NEP set out to engineer a major distributional transformation of the Malaysian economy, and in its early stages made remarkable progress. Built into the implementation of the NEP were mechanisms to monitor, evaluate, and, where possible, to adjust the linkages between economic growth and distribution. The distributional consequences of policies—that is, their inclusiveness—will need to be highlighted and given attention. Transparency regarding the potential and actual distributional consequences of policies is also desirable, although this is unlikely to be easy in many political environments.

Seventh, leadership has played a crucial role in Malaysia's economic development. Overall, there was political stability and security, which helped growth. The *Barisan Nasional*, a coalition government comprising the three major ethnic groups, managed to contain the inherent tendencies towards inter-ethnic conflicts and succeeded in sustaining the political and social commitment to the growth process. The emphasis on growth with equity, despite the difficulties, helped to sustain stability. Adjustments to the growth-with-equity policy thrust will always be needed, and the continued success of Malaysia's economic growth efforts will depend on how well this is managed.

In addition to the above, and as described in earlier sections, elements of the Malaysian experience help inform some of the debates on development strategy. Most important, they suggest that both conceptually and in practice, it is impossible to act sequentially upon a series of real or perceived "binding constraints." In fact, it is impossible to identify the boundaries of a "constraint," and ex post appraisals of economic history are less than credible when they employ elastic approaches in order to make a case for a researcher's particular biases. Instead, it is more appropriate to view the conceptualization and implementation of development policies in a "reform clusters" framework, as exemplified by the Malaysian experience. The motivations for packaging reforms into clusters are complex, but in general they are based on coordination concerns. Clusters are useful not just for mobilizing popular support and fragmented administrative skills; they may ease legislative passage and make better use of synergies and spillovers among the reform areas. Much of the recent "binding constraints" approach seems to have been derived from a misreading of the Chinese development experience. As in China, far from acting on one constraint at a time, Malaysian policy makers acted simultaneously on several fronts, at each stage of their development implementing a cluster of reforms covering a wide range of coordinated economic activities.

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Malaysia is a multiethnic, upper-middle-income country that has relied heavily on income from its natural resources to engineer successful diversification into manufacturing and sharply increased incomes for all ethnic groups. This paper examines the role of the policy-making process and national leadership in effecting this structural change and growth with equity. It discusses the government's role in transforming corporate ownership patterns while nurturing industrial enterprises into niche products within complex value-added chains. At the same time, the paper underscores the difficulties and costs of attempting to move into areas where an economy has no strong advantages, in this case heavy industries. Privatization, although a powerful tool for expanding private enterprise despite limited entrepreneurial skills, is questionable as a sustainable strategy. Aggressive formation of new firms seems to offer better long-term prospects, along with an appropriate policy-making and implementation regime characterized by political determination, stability, high attention to growth with equity, experimentation, and an ability to learn through implementation—both at home and from the experience of others. Furthermore, evidence suggests that the "reform cluster" approach to policy implementation can address effectively several coordination problems at the same time.

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